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A COMPARATIVE STUDY OF SHAREHOLDERS' DERIVATIVE ACTIONS

England, the United States, Germany and China

A Comparative study of shareholders' derivative actions

England, the United States, Germany and China

Xiaoning Li

Kluwer – Deventer – 2007

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Preface

On December 11, 2006 mrs. X. Li was awarded a Ph.D. *cum laude* by the University of Groningen (the Netherlands) for this thesis *A Comparative study of shareholders' derivative actions*, supervised by Professors dr. L. Timmerman and dr. M.L. Lennarts. It is with great pleasure that I present this Ph.D. dissertation in the series of the Institute for Company Law of the University of Groningen, the Netherlands.

The main objective of the study of Xiaoning Li is to provide insight in the nature, (dis)advantages and functioning of derivative shareholder litigation. In several countries derivative suits are a notable constraint on director mismanagement. Derivative litigation by shareholders is an important issue in the ongoing debate on principles of corporate governance and protection of minority shareholders. To prevent abuse, however, derivate suits are often limited by a variety of procedural and substantive restrictions.

This study is comprised of six chapters. After a general introduction (chapter 1), Xiaoning Li analyses the law of derivative actions in three Western countries: England (chapter 2), the United States (chapter 3) and Germany (chapter 4). Derivative suits in these countries have their own characteristic features. Chapter 5 studies the law of the People's Republic of China. This study illustrates that in the field of company law very important developments took place in the last years. As from January 1, 2006, a broadly amended new Company Law came into force, meeting the needs of China as a rising economic superpower. The development of derivative suits in China, which has a civil law tradition, is worth noting. In the final chapter (chapter 6) Xiaoning Li concludes that the issue of how to strike a balance between corporate efficiency and protection for the company and its minority shareholders is key in derivative actions.

This excellent study provides a thorough, comparative analysis of the techniques of derivative actions. I have no doubt this book will contribute to the better understanding of derivative litigation and that it will be welcomed by legal professionals and scholars all over the world as a valuable resource.

Prof. dr. Jan Berend Wezeman
Institute for Company Law of the University of Groningen, the Netherlands

‘… no single technique of accountability (including market and legal remedies) is likely to be optimal under all circumstances. Each has its characteristic and well-known limitations, and, as a result, shareholders are best served by an overlapping system of protection.’

(American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations (II)*, St Paul, Minnesota: American Law Institute Publishers, 1994, part VII, chapter 1, Introductory Note, p. 5)

‘The basic methodological principle of all comparative law is that of *functionality*. From this basic principle stem all the other rules which determine the choice of laws to compare, the scope of the undertaking, the creation of a system of comparative law, and so on. Incomparables cannot usefully be compared, and in law the only things which are comparable are those which fulfil the same function.’

(K. Zweigert & H. Kötz, translated by Tony Weir, *An Introduction to Comparative Law (third Edition)*, Clarendon Press, Oxford, (1998), p. 34)

Preface from the author

Company law, including the law on shareholders' derivative action, has experienced significant changes in many countries since I started writing this book. For example, the new German law for stock companies (the UMAG) has come into effect as of November 2005, China has also widely amended its own company law, which came into force as of January 2006, and a new British Companies Bill will also soon come out. These changes actually have made my research far more interesting than I would have expected.

Over these past years I have always been asked why I chose to conduct my research in the Netherlands, which does not have the technique of shareholders' derivative action and is not a subject of my research. Yes, it might sound strange. In fact, it was more a matter of coincidence that I came to the Netherlands, a beautiful small country. But it has turned out to be the best choice I could have made. Although there is no derivative action in Dutch company law, there have been arguments both for and against introducing it into the Netherlands. These arguments have inspired the Dutch to study the derivative action from different points of view and to take a more objective attitude towards it. In addition, the Dutch have also been interested in observing law and its application in various countries in addition to their own law. This diversity of viewpoint, together with the language talents of the Dutch, has significantly contributed to my comparative research.

Litigation is also a social phenomenon. It is influenced by factors such as legal tradition and culture. These influences would be a topic for a totally different area of research, so I will not, nor am I able to, touch upon them here. Nevertheless, this aspect of comparative research may provide an interesting subject for further study in this field.

English law tends to use the term 'company,' while American law 'corporation.' Therefore, 'company' and 'corporation' are used alternately in this book.

Xiaoning Li
October 2006
Groningen, the Netherlands

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Select abbreviations

A. 2d.	Atlantic Reporter Second Series
AC	Appeal Cases
App. Cas.	Appeal Cases
ACLR	Australian Company Law Reports
A.D. 2d	Appellate Division Reports Second series (New York)
aff'd	Affirmed
AG	Aktiengesellschaft (German Stock Company)
AktG	Aktiengesetz (German Stock Company Act)
ALI	American Law Institute
All E.R.	All England Law Reports
Am. J. Comp. L.	The American Journal of Comparative Law
AZJICL	Arizona Journal of International and Comparative Law
BCC	British Company Law Cases
BCLC	Butterworths Company Law Cases
BGH	Bundesgerichtshof (German Federal Supreme Court)
BGHZ	Entscheidungen des Bundesgerichtshofs in Zivilsachen (Decisions of the Federal Supreme Court in Civil Cases)
BKNJIL	Brooklyn Journal of International Law
Brook. L. Rev.	Brooklyn Law Review
BSPM	Bureau of State Property Management
B.U. L. Rev.	Boston University Law Review
Bus. Law.	Business Lawyer
B.Y.U. L. Rev.	Brigham Young University Law Review
CA	Companies Act
Cal. App. 2d	California Appellate Reports Second Series
Cal. Rptr.	California Reporter
cert. denied	Certiorari denied
CfiLR	Company, Financial and Insolvency Law Review
Ch	Chancery Division 1991-
Ch. App.	Chancery Appeal 1865-75
Ch. D.	Chancery Division 1875-90
CLJ	Cambridge Law Journal
CLR	Company Law Review Steering Group
CNLILJ	Cornell International Law Journal

Colum. L. Rev.	Columbia Law Review
Comp. Law.	The Company Lawyer
Cornell L. Rev.	Cornell Law Review
CP	Consultation Paper
CPR	Civil Procedure Rules
CSRC	China Securities Regulation Committee
Del. Ch.	Delaware Chancery Report; Delaware Chancery Court
Del. J. Corp. L.	Delaware Journal of Corporate Law
DGCL	Delaware General Corporation Law
DJT	Deutscher Juristentag
D&O	Direct and Officer
DTI	Department of Trade and Industry
Duke L.J.	Duke Law Journal
ECFR	European Company and Financial Law Review
ed Editor	
EN	Explanatory Note
EWHC	High Court (England & Wales)
F. 2d, F. 3d	Federal Reporter (Second Series) (Third Series)
Fordham L. Rev.	Fordham Law Review
F. Supp.	Federal Supplement
Geo. Wash. L. Rev.	George Washington Law Review
GmbH	Gesellschaft mit beschränkter Haftung (German Limited Liability Company)
GmbHG	Gesetz betreffend die Gesellschaften mit beschränkter Haftung (German Limited Liability Company Act)
Harv. Int'l L.J.	Harvard International Law Journal
How.	Howard's United States Supreme Court Reports
HVLR	Harvard Law Review
IALR	Iowa Law review
I.C.C.L.R.	International Company and Commercial Law Review
IFLR	International Financial Law Review
IND. L. J.	Indiana Law Journal
Ind App	Indiana Court of Appeals Reports, Indiana Appellate Court Reports
JBL	Journal of Business Law
J. Corp. L.	Journal of Corporation Law
J.L. Econ. & Org	Journal of Law, Economics and Organization

KonTraG	Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (Law on the Control and Transparency in Business)
L.Ed., L.Ed. 2d	United States Supreme Court Reports (Lawyers' Edition) (Second Series)
L.J.	Lord Justice
LQR	Law Quarterly Review
Mass.	Massachusetts Reports
Mass. L. Rev.	Massachusetts Law Review
MBCA	Model Business Corporation Act
Mich. J. Int'l L.	Michigan Journal of International Law
Misc.	New York Miscellaneous Reports
Miss.	Mississippi Reports
MLR	Modern Law Review
MNLR	Minnesota Law Review
MSA	Minnesota Statutes Annotated
N. C. App.	North Carolina Court of Appeals Reports
N.D.N.Y.	US District Court for the Northern District of New York
ND ST	North Dakota Statutes
N.E., N.E.2d.	North Eastern Reporter (Second Series)
Neb.	Nebraska Reports
N. J.	New Jersey Reports
N.W., N.W.2d.	North Western Reporter (Second Series)
Nw. U. L. Rev.	Northwestern University Law Review
N.Y. Ch.	New York Court of Chancery
N.Y.L.J.	New York Law Journal
N.Y., N.Y. 2d	New York Reports (Second Series)
N.Y. S. 2d	New York Reports Supplement Second Series
NZLR	New Zealand Law Reports
Otto	Ottos United States Supreme Court Reports
P., P2d.	Pacific Reporter (Second Series)
Pa.C.S.A	Pennsylvania Statutes and Consolidated Statutes Annotated
Paige	Paige's Chancery Reports
Ph	Phillip's Chancery Reports
QB	Queen's Bench Division
Rev'd	Reversed
RSC	Rules of the Supreme Court

SCLR	South Carolina Law Review
SCSC	State Council Securities Committee
S.Ct.	Supreme Court Reporter
S.D.N.Y.	US District Court for the Southern District of New York
S.E., S.E.2d.	South Eastern Reporter (Second Series)
SI	Statutory Instrument
S.L.T.	Scots Law Times
So., So.2d.	Southern Reporter (Second Series)
SOE	State-Owned Enterprises
SOX	Sarbanes-Oxley Act
SPC	Chinese Supreme People's Court
SSE	Shanghai Securities Exchange
Stan. L. Rev.	Stanford Law Review
STJJLC	Saint John's Journal of Legal Commentary
St. Louis U. L.J.	Saint Louis University Law Journal
S.W., S.W. 2d	South Western Reporter (Second Series)
T.L.R.	Times Law Reports
Tul. L. Rev.	Tulane Law Review
U.C. Davis L. Rev.	U.C. Davis Law Review
U. Chi. L. Rev.	University of Chicago Law Review
UK	United Kingdom
UMAG	Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts (German Act Regarding Integrity of Companies and Modernization of Shareholder Suits)
UMKC L. Rev.	University of Missouri-Kansas City Law Review
UNSWLJ	University of New South Wales Law Journal
U. Pa. L. Rev.	University of Pennsylvania Law Review
U. Pa. J. Int'l Econ. L.	University of Pennsylvania Journal of International Economic Law
U.S.	United States Reports; United States
U.S.C.	United States Code
Va. L. Rev.	Virginia Law Review
Vand. L. Rev.	Vanderbilt Law Review
W.D.Pa.	US District Court for the Sestern District of Pennsylvania
WL	WESTLAW Citations
WLR	Weekly Law Report
ZPO	Zivilprozessordnung (German Civil Procedure Code)

Chapter 1

Introduction

1.1 The nature of derivative action

1.1.1 The proper plaintiff principle

When harm has been done to a company (corporate injury or corporate wrong), the general principle is that an action against such misconduct should be pursued by the company and that damages should also be awarded to that company. This is called the proper plaintiff principle. Other persons, such as individual shareholders or creditors, cannot bring an action to redress this misconduct even though their interests may also be indirectly infringed by that misconduct. To give an example: the shareholders' interests could be indirectly injured because the value of their shares decrease due to the corporate losses, and the creditors' interests could also be infringed if the loss suffered by the company is so great that the company goes bankrupt and is not able to repay the debts owed to them.

There are several justifications for this general proper plaintiff principle. First, a company is a legal entity distinct from its stakeholders and has its own legal capacity for enjoying legal rights and taking legal responsibility. Although this separate legal entity is only a fiction created by law, it is a cornerstone of modern company law. A company can pursue an action in its own name when its interests have been injured, just as it can do business in its own name. Second, in a corporate action where the remedies, if allowed, are awarded to the company, the interests of all stakeholders, including creditors and shareholders, can be indirectly protected. However, if an individual shareholder brings a direct action on his own behalf, only that plaintiff shareholder will benefit from the action. Third, it is submitted that it should be up to the company, through appropriate bodies such as the board of directors, rather than an individual shareholder to decide whether an action is in the best interests of the company because these bodies have greater knowledge of the company's management and are themselves more professional. Finally, the requirement that an action can only be brought by or on behalf of the injured company is aimed at avoiding multiple litigation.

1.1.2 The nature of derivative action

1.1.2.1 The derivative action as an exception to the proper plaintiff principle

According to the proper plaintiff principle, the injured company should decide whether to bring an action against the wrong done to it. However, since it is not a natural person, the company has to make such a decision via an appropriate body. Normally a decision as to whether to bring a corporate action is in essence a business one and so is generally made by the board of directors. Where there is corporate wrong, the board of directors has the discretion to make a litigation decision based on its business judgment. The board can decide not to pursue an action against the wrongdoer if it thinks the company will not benefit from such an action. However, under certain circumstances the board cannot make a fair litigation decision. For example, when the directors are the wrongdoers committing corporate misconduct or are controlled by these wrongdoers, they may prevent the company from filing an action against this misconduct. Thus, in order to redress the damage to the company, other bodies or persons other than the board of directors must have the right or power to make a litigation decision based on the best interests of the company under such circumstances. How to identify such an appropriate body becomes a difficult issue in company law. Practice shows that several strategies, such as the decision-making strategy and the trusteeship strategy, have been gradually developed in various countries.[1] Under the decision-making strategy, shareholders may enforce corporate claims collectively through the general meeting or a group of shareholders (such as disinterested shareholders); while under the trusteeship strategy, internal trustees such as the supervisory board, the independent directors or a special litigation committee, or external trustees such as the court or court-appointed special representatives, may decide whether to enforce corporate claims or allow such claims. Nevertheless, since each strategy has its own deficiencies[2], there is still no single right answer to this difficult issue. The comparative study in this book will show how various countries have tried to solve this issue.

The derivative action is one of these strategies, one that developed rather early in common law countries: a shareholder or several shareholders may, under certain circumstances, sue on behalf of the company in respect to a corporate wrong against which no other remedy may be available. Since they are not corporate bodies, the plaintiff shareholders have to bring the suit in their own names. Their

1 For a detailed discussion of these strategies and their advantages and disadvantages see, for example, Hirt (2005a). The practice in various countries will be discussed in the main parts of this book.

2 For a detailed discussion of the issue, see Section 6.3.2.

right to sue actually derives from the company's right of action and therefore the action is named derivative action. Thus, the derivative action is an exception to the proper plaintiff principle. The very fact that it is an exception determines that the derivative action can only be applied in limited circumstances. Although there are other limitations, basically no derivative action may be brought if the board of directors can make its own litigation decision in good faith; minority shareholders can only challenge the board's decision where the board has not been able to perform its duty correctly. Therefore, derivative action is basically a method by which shareholders hold directors, officers and other fiduciaries accountable.

1.1.2.2 The nature of 'derivative' and 'representative'

The shareholder's right to derivative actions derives from the company's right to action. It is distinguished from a shareholder's 'direct action' which the shareholder can bring where his own right has been infringed.[3] In derivative actions, although it is the shareholders who indirectly suffer the loss, this indirect loss cannot be the cause of action.[4]

Apart from the nature of 'derivative,' the derivative action also has a 'representative' character. It is an action brought by the plaintiff on behalf of the injured company which has wrongfully failed to redress a corporate wrong. In such cases, even if the plaintiff is the only shareholder and thus the only one who has indirectly suffered from the misconduct, he still needs to bring the action in terms of representing the injured company. On the other hand, in most derivative action cases there is more than one shareholder in the injured company and not all of them are plaintiffs in the suit. Like the plaintiff shareholder, all non-plaintiff shareholders will be indirectly influenced by the result of the suit. In this sense, the plaintiff shareholder bringing the derivative action also represents all other shareholders. However, this representative nature of derivative actions should not be confused with representative actions or class actions because the latter two kinds of action are still direct actions: shareholders bring representative actions or class actions because their personal interests have been infringed upon.

Due to the 'derivative' and 'representative' nature of the derivative action, the proceeds of the action, if any, must go to the company rather than to the plaintiff shareholder.[5] The successful or good faith plaintiff should, however, also be reimbursed for the expenses incurred in the suit. Once any judgment or settlement comes into effect, neither the company nor other shareholders can bring an action based on the same claims that have already been raised in this derivative action.

3 I will discuss the distinction between direct action and derivative action in detail later.

4 For a further discussion of this issue and the latest legal developments, see Ferran (2001).

5 In US law there are exceptions; see Section 3.3.4.

1.2 Justifications for derivative action

1.2.1 Derivative action justified by its function

As mentioned above, derivative actions have been developed because in some circumstances the injured companies cannot seek relief themselves. Redressing corporate wrongs which no other mechanisms can remedy is a fundamental justification for the existence of derivative actions. Through a derivative action, the injured company can acquire compensation which it might not have acquired if the board failed to bring an action in the name of the company. As a result, the interests of the injured company and its shareholders are protected.

Derivative actions also have the functions of deterrence and education.[6] By providing sanctions the derivative action not only has a deterrent role, affecting the future behavior of the wrongdoers, but also acts as a general deterrent against all corporate mismanagement. This deterrent role is more effective if social disgrace is attached to the wrongdoers.

Although other mechanisms, such as market mechanisms, can also police corporate management and play the same role as compensation and deterrence, the derivative action has its own advantages. It provides judicial oversight that is generally regarded as fair and just, although it is costly and time-consuming.[7] It also has the advantage that a single shareholder or a group of shareholders can trigger the procedure to protect the company's interests, avoiding the trouble of taking collective or coordinated action.[8] Although there is the risk of derivative action being abused by shareholders, it does provide shareholders with the opportunity to seek redress that might not be obtained otherwise. These advantages, although coupled with disadvantages[9], justify the role of derivative action in protecting companies and minority shareholders' interests and in policing corporate management, provided that the derivative action is well devised.

1.2.2 Derivative action justified from an economic perspective

Justifications for derivative action can also be made from an economic perspective.[10] First, the derivative action may reduce average agency costs. Although other mechanisms, such as contracting, market signaling, monitoring devices, and the market threatening the removal of the directors, may reduce agency costs, they are only efficient if the marginal costs do not exceed the marginal benefits.[11] As

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6 See ALI (II), Part VII, Chapter 1, Reporter's Note, p. 12.

7 ALI (II), Part VII, Chapter 1, Introductory Note, p. 5.

8 ALI (II), Part VII, Chapter 1, Introductory Note, p. 5.

9 I will discuss the disadvantages of the derivative action in Section 1.3.

10 See ALI (II), Part VII, Chapter 1, Reporter's Note, pp. 14-16; Cox et al. (2001), pp. 15.2-15.12. However, Fischel and Bradley do not agree with the economic justifications; see Fischel & Bradley (1986), pp. 288-292.

11 Cox et al. (2001), pp. 15.3-15.5.

a result, they might not be capable of disciplining all misconduct. The derivative action, however, when carefully regulated, can provide a better solution in some circumstances. Since in a derivative action the plaintiff's attorney is a specialist and shareholders' collective action is normally unnecessary, the derivative action is an efficient method for compensating the injured company and deterring misbehavior, especially so-called 'one shot' breaches of duties, which may not be effectively policed by other mechanisms.[12] Second, the derivative action is justified by the portfolio theory. Because derivative action has a general deterrent role, affecting all corporate management, and because most shareholders hold a portfolio of securities, the shareholders will benefit from the collateral effect of a derivative action due to their holding of shares in other companies.[13] Although the shareholders might suffer a loss in that specific company if the costs of the derivative action exceed the recovery it obtains, this loss might turn out to be less, due to the benefit they acquire from those other companies.

1.3 Disadvantages of derivative action

1.3.1 Risk of unjust interference in corporate management

Derivative action is deemed to have some problems due to its very nature. The individual shareholder's right to bring a derivative action may interfere with corporate management. This can happen when a derivative action is abused by a malicious shareholder for its nuisance or settlement value.[14] A derivative action brought by a *bona fide* shareholder can also interfere with corporate management. Since an individual shareholder normally knows little about the management of the company and may not be an expert on business matters, he may bring a non-meritorious action. As a result, preventing corporate management from being unduly interrupted by unnecessary derivative actions is a major issue faced by legislators. It is also a major issue I will be discussing in this book.

1.3.2 The plaintiff's weak incentive

Another problem with the derivative action is the weak incentive for the plaintiff shareholder to pursue a derivative action for the benefit of the company. Since the recovery in a derivative action will go to the company, the plaintiff shareholder benefits little from the consequences of the litigation. On the one hand, if the plaintiff wins the action, the damages will be awarded to the company and the

12 ALI (II), Part VII, Chapter 1, Reporter's Note, pp. 15-16.

13 I have to admit, however, that it is almost impossible to calculate this benefit.

14 Abuse of derivative action for its settlement value is especially common in the US. In the US, the derivative action is usually controlled by the plaintiff's attorney. The plaintiff's attorney is likely to make a settlement for his own benefit rather than the company's benefit. For details, see Section 3.4.4.3.

plaintiff shareholder will only indirectly benefit through the shares he owns. This indirect benefit is usually small and not obvious, especially when the plaintiff shareholder only owns a very small percentage of the shares of the company.[15] On the other hand, if the plaintiff loses the case, he may end up bearing little of the costs; the company may well reimburse him for his litigation costs.[16] Because of his small stake in the company, an individual shareholder has very little incentive to pursue the derivative action simply in the best interests of the company.

This weak incentive can have two different consequences. On the one hand, there might be very few derivative actions brought by shareholders. Since shareholders will not benefit from the action, usually they do not bother to bring one. This is especially possible in public companies where the minority shareholders usually have the free-ride problem. This lack of incentive for the minority shareholder to bring a derivative action is also called the under-incentive problem. On the other hand, the derivative action might be driven by plaintiff shareholders and/or their attorneys in their own interests, regardless of the interests of the company and other shareholders. This is known as the over-incentive problem. For example, in the US, derivative actions are mostly lawyer driven. In most cases, the lawyer's interests are by no means congruent with the plaintiff's and the company's interests. The attorney's interest lies in the amount of money received less the costs spent on the case, including both time and money. This is not necessarily proportionate to the recovery awarded to the company.[17] In practice, the attorney's interest is usually better served by settlement, which can provide a relatively high attorney fee with lower costs due to the reduced work involved in preparing the case and taking it to trial, and also because in a settlement the attorney never incurs a risk of losing, while in a trial he does. If he loses the case, he will get nothing for his work.[18] Both of these consequences may hinder the functioning of derivative action: the injured company may not be compensated and the abuse of the derivative action weakens the deterrent role of derivative action.

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15 This is the normal case in derivative actions, especially in the case of public companies. On the one hand, because there is normally no legal requirement for the plaintiff shareholder to have a minimum percentage of shares, except in some continental European countries such as Germany, any shareholder who satisfies the requirements of bringing a derivative action can do so, even if he only owns one nominal share. Even in Germany where there is a capital threshold, the capital threshold is not very high in the sense of the percentage of the shares. On the other hand, normally a majority shareholder who might have more financial interest will not bring a derivative action as there are better ways of policing management, such as by removing the directors.

16 The costs the plaintiff shareholder needs to pay vary in various countries. For details on this issue, see Sections 2.41.4, 3.4.4, 4.4.1.4, 4.4.2.2.3, and 5.4.4.

17 Cox (1999), p. 33.

18 This is also the reason why the rate of settlement is so high in American derivative action cases. For the evidence of this high rate of settlement, see the empirical studies which have been done in the US.

1.3.3 Problems of corporate recovery

Corporate recovery also creates problems in derivative actions. For example, first, if the wrongdoer still controls the company after the suit, the recovery awarded to the company will still be under the control of the wrongdoer who could engage in misconduct again. This is especially possible when the wrongdoer is the majority shareholder, because a majority shareholder cannot be removed as easily as a director. Second, if the wrongdoer is also a shareholder in the damaged company and still holds the shares after the action, he, like any other shareholder in the company, will also *pro rata* benefit from the action indirectly. This is contradictory to the rationale that compensation should not go to the wrongdoer, and, of course, the role of derivative action in deterring the wrongdoer will be greatly reduced as well. Third, a corporate recovery may bring about a windfall for some shareholders, especially shareholders in publicly traded companies. In publicly traded companies, ownership of shares constantly changes and there are at least two groups of shareholders: one group who bought their shares before the misconduct was disclosed and continues to hold the stock at a loss, and another group who bought the shares after the disclosure at a deeply discounted price.[19] This latter group of shareholders may benefit from a windfall: normally they have suffered no loss due to the disclosure of the misconduct, but they will nonetheless benefit from the derivative action in proportion to the shares they own because a corporate recovery has been awarded in the derivative action and no distinction can be made among different groups of shareholders.

1.4 The role of derivative action

1.4.1 Corporate governance as a comprehensive system

It is generally recognized that in order to improve corporate governance, a plurality of mechanisms has to be developed, and the derivative action is only one of the mechanisms protecting the interests of companies and shareholders and policing corporate management.[20] '[C]orporate governance is a system. It has its foundations partly in company law, setting out the internal relationships between the various participants in a company, and partly in the wider laws and practices and market structures ...'.[21] In this system, the mechanisms improving corporate governance include both *ex ante* methods, which prevent misconduct and reduce

19 There is also a group of former shareholders who bought their shares before the misconduct was disclosed but who sold right after the disclosure at a deeply discounted price. Since they are no longer shareholders they are unable to benefit from the derivative action against the misconduct. Thus, their loss may not be compensated unless they can satisfy the requirements for bringing a direct action and be compensated that way.

20 For example, see ALI (II), Part VII, Chapter 1, Introductory Note, p. 5.

21 Winter Report (2002), p. 44.

agency cost[22], and *ex post* remedies, which compensate the injured party and hold the wrongdoers accountable.[23] None of the mechanisms are likely to be optimal under all circumstances since 'each has its characteristic and well-known limitations.'[24] Derivative action is only one kind of *ex post* legal remedy, and perhaps the last resort for shareholders both because of the expense in terms of time and money incumbent on lawsuits and because of the particular disadvantages of derivative actions, which we have already discussed above. The English Law Commission also states that 'Prevention is better than cure.'[25]

1.4.2 Different approaches towards the role of derivative action

Although it is commonly recognized that an overlapping system should be developed, there may be differing opinions concerning the role or status of any one particular mechanism. It could be maintained that every mechanism is as important as any other. It could also be maintained that some mechanisms work more effectively and efficiently than do others and so perform a more important role. The first assumption is hardly ever held since it is almost impossible for all the different mechanisms to perform the same role in varying situations. Thus, the main controversy lies in the role played by each mechanism.

The same controversy has arisen with derivative actions. Basically, there are three different approaches towards the role of the derivative action. One is that the derivative action is 'the chief regulator of corporate management,'[26] while another approach considers it as 'neither the initial nor the primary protection for shareholders against managerial misconduct,'[27] and, finally, a third approach finds that derivative action scarcely serves any role at all.[28]

In practice, though, the derivative action does perform different functions in various situations. The role of the derivative action varies according to country. For example, in the United States the derivative action plays an important role[29], while in England in actual practice the derivative action is much less important

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22 Other mechanisms include, for example, shareholders' rights of voice and exit, the requirement of disclosure, the existence of independent directors and auditors, market forces and public enforcement.

23 For example, removal of directors, exit right of shareholders, the disciplinary power of the market such as takeovers, legal suits and public enforcement.

24 ALI (II), Part VII, Chapter 1, Introductory Note, p. 5.

25 See Law Commission Report 246 (1997), executive summary, p. 6.

26 *Cohen v. Beneficial Industrial Loan Corp.* 337 US 541, 548, 69 S.Ct. 1221, 1226 (1949).

27 ALI (II), Part VII, Chapter 1, Introductory Note, p. 5. The English Law Commission also held that the derivative action was "not common but … an important mechanism of shareholder control of corporate wrongs," see Law Commission Report 246 (1997), executive summary, p. 5.

28 For example, in the UK there was a body of opinion which held that the derivative action was of little use in practice and that there was no need to reform it. See Law Commission Report 246 (1997), para. 6.10.

29 See Section 3.2.

than other remedies such as the unfair prejudice petition.[30] In Germany also, the minority shareholders' right to enforce corporate claims does not play an important role in protecting the company's and the minority shareholders' interests.[31] The derivative action also plays a different role in different types of companies. This also varies in different countries. In England, the derivative action is not regarded as a major method for protecting minority shareholders in public companies. In the United States, on the contrary, derivative actions are frequently brought against wrongdoers in public companies. In Germany, the derivative action only applies to stock corporations. These different approaches may show the relationship between the derivative action and other methods of protection: the more effective other methods are, the less important a role the derivative action may play. The derivative action is only the 'last resort' for minority shareholders. Nevertheless, recent reforms in many countries throughout the world show a convergence towards an intermediate approach: the derivative action is necessary to protect the company and shareholders, but there must also be restrictions on the application of this mechanism in order to balance corporate efficiency with protection of the company and shareholders.

1.4.3 Factors affecting the function of derivative action

Many considerations, besides those based on the advantages and disadvantages of the derivative action, affect legislative and judicial attitudes towards the derivative action. First, the policy consideration aimed at balancing corporate efficiency with company/shareholder protection will affect the approach taken towards the role of derivative action. If the balance favors corporate management, normally the derivative action will play a less important role, while if the balance favors company/shareholder protection, there will be a more important role for the derivative action. Furthermore, the balance will tilt according to several factors. For example, if the market is notorious for poor investor protection, the balance may tend to favor shareholder protection. In contrast, when economic growth is the major concern, the balance may tend to favor corporate management.

Second, the attitude towards the issue of which is the appropriate body to make a litigation decision in the best interests of the company where the board of directors has a conflict of interest will also affect the role of derivative actions. If other bodies such as the independent directors or independent shareholders are regarded as being more appropriate than an individual shareholder for making such a decision, the individual shareholder's right to bring a derivative action will be subject to the decision of such bodies. As a result, the derivative action will play a less important role.

30 See Law Commission Report 246 (1997), executive summary, p. 3.

31 See Section 4.2.

The third factor is whether the derivative action is aimed at protecting minority shareholders' interests or the company's interests as a whole. Although it is pursued to redress a corporate wrong, traditionally the derivative action is regarded as an important mechanism for protecting minority shareholders' interests. The reason is that the ultimate purpose in protecting companies' interests is to protect company stakeholders' interests, which are primarily the interests of shareholders and creditors. However, it is not the creditors' interests which are primarily protected by the derivative action, because the creditors' interests will not be infringed as long as the injured company is not bankrupt. In addition, if the company is bankrupt, the principle that creditors have a prior claim to the corporate assets over shareholders under bankruptcy law provides a further major protection for creditors. As a result, in most countries, creditors are not allowed to pursue a derivative action where the company is still solvent. As far as majority shareholders are concerned, it is not necessary for them to pursue derivative actions because normally they control the general meeting of shareholders and sometimes also the board of the directors. They are thus able to redress any misconduct by other methods such as removing the wrongdoers, if they themselves are not the wrongdoers. As a result, protecting minority shareholders is the main concern of the derivative action.

Although as far as the result of derivative action is concerned there is no difference between protecting companies and minority shareholders in most cases, the issue of whose interests are going to be protected does affect the role of derivative actions. If the purpose of the derivative action is to protect the company's interests rather than merely the interests of shareholders, a derivative action should be brought and the remedy should be awarded to the company as long as there is a corporate wrong. However, if the purpose is to protect minority shareholders even in cases of corporate wrong, all remedies that can redress the aggrieved shareholders will be regarded as sufficient even if they may not compensate the injured company. For the aggrieved shareholders, however, compensation may not be the only remedy; other remedies such as an exit right may also provide relief for them, especially in private companies. Therefore, more favorable alternative mechanisms may be available and so the derivative action may end up playing a less important role. For example, in England the unfair prejudice remedy plays a more important role than the derivative action, and to some extent it substitutes for the derivative action. Minority shareholders can bring an unfair prejudice petition in the case of a corporate wrong if they can prove that they are suffering unfair prejudice, and the most common remedies in these cases are 'purchase out.' Therefore, the interests of non-petitioner shareholders and of the injured company may be neglected in such cases. The underlying policy, though, is that the derivative action is intended to protect aggrieved minority shareholders; if other mechanisms such as the unfair prejudice remedy can protect the aggrieved shareholder, the derivative action may not be brought. Finally, if the derivative action is aimed at protecting the interests of the company rather than those of the minority shareholders, there may be fewer alternatives to the derivative action and its role thus becomes more important.

Fourth, the attitudes towards the relationship between the compensatory and deterrent functions which the derivative action serves will affect the role of the derivative action. Commonly there is no conflict between the two functions because to hold the wrongdoers accountable to the injured naturally also provides a deterrent effect: the liability of compensation will discourage future misconduct. However, there are exceptions. Where the misconduct did not cause damage to the company, should a derivative action be allowed? In such cases, though no compensatory goal will be served because no damage has been suffered by the company, a deterrent function may result if there is a successful action against the wrongdoer. In this case, the two functions served by the derivative action conflict with each other.

The attitudes towards these two conflicting functions will affect the role of the derivative action. For example, if compensation is the prevailing purpose behind derivative action, shareholders cannot bring a derivative action if there is no loss to the company or to the plaintiff shareholders.[32] As a result, the standing criteria for bringing a derivative action become stricter and situations where a derivative action can be brought will be limited. The role of the derivative action in company law, especially in policing corporate management, becomes less important. On the other hand, if the deterrent function prevails, a derivative action will be allowed even if the corporate misconduct has not caused damage and therefore the derivative action will play a more important role in a greater number of situations. However, due to the danger of overdeterrence, there have to be limits placed on the deterrent role. How to strike an appropriate balance between these two functions has become a difficult issue in derivative actions.

Fifth, the effect of the compensatory and deterrent functions and the attitudes towards their effect will affect the role of the derivative action. The more optimistic they are about the effect of these functions, the more important legislators think the derivative action should be. Although empirical studies have been conducted in order to see whether derivative actions provide compensation to shareholders[33], the effect of the deterrent role is by its nature immeasurable by empirical studies. Moreover, the veracity of these empirical studies is not without doubt.[34]

Last but not least, the attitudes towards private enforcement and public enforcement will affect the role of derivative action.[35] For example, it is generally recognized that in the US extensive government intervention is not welcome and so public enforcement is not favored. As a result, in order to solve disputes,

32 For a detailed discussion, see Section 3.2.4.1.2.1.
33 For example, in the US; see Section 3.2.4.2.
34 See ALI (II), Part VII, Chapter 1, Reporter's Note, p. 12.
35 This factor needs to be proven.

private enforcement, including litigation, is turned to. This may at least partly explain why litigation, including shareholders' suits, is so popular in the US.[36] On the other hand, if there is a greater reliance on public enforcement the role of litigation may be limited. An example is England, where unlike the US, extensive and robust public enforcement has been developed as an effective supplementary tool for private enforcement.[37]

1.5 Comparative study

1.5.1 Derivative action as a generally accepted mechanism

The essence of the derivative action lies in awarding to an individual shareholder or a group of minority shareholders the right to enforce corporate claims on behalf of the injured company in exceptional circumstances. Whether it is called derivative action or not, this method of protecting the interests of companies and shareholders has been chosen by various countries. It is a common phenomenon in these countries that a board may not be willing to bring an action against the wrongdoers where the board members themselves are the wrongdoers or where they are substantially under the wrongdoers' influence or have a personal interest in condoning the wrong or simply have personal relationships with the wrongdoers. As a result, the importance of protecting the interests of companies and shareholders has been recognized in these countries. Various methods have subsequently been developed to solve this problem, among them is empowering an individual shareholder or a group of shareholders with the right to enforce the corporate claim. However, due to different legal and social backgrounds, the specific regulations on how to enforce this right of action vary in these countries. For a better understanding of the derivative action, this book has chosen four jurisdictions for its comparative research, England, the United States, Germany and China.[38]

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36 More and more academics in the US argue that the popularity of litigation in the US is the logical response to the characteristic distribution of power in the US and to a historical distrust of a powerful government, rather than plain and simple greed, see Eviatar (2002).

37 Such as sections 432 (appointment of inspectors) and 447 (investigation of company documents) of The UK Companies Act, where the Secretary of State has extensive investigation and petition powers. See Kraakman et al. (2004), p. 117; Davies (2003), p. 467.

38 Comparative research provides an important method of knowledge; see Zweigert & Kötz (1998), p. 15.

1.5.2 The countries chosen for the comparative study

1.5.2.1 England[39]

The law of derivative actions originated in English law. According to English law, an individual shareholder may bring a derivative action provided he satisfies the requirements for bringing such an action. English law, which is famous for the *Foss* rule, has established the basic principles behind derivative actions: the proper plaintiff principle, the majority rule principle which reflects the principle of non-interference in business matters, and the principle of keeping a balance between corporate efficiency and minority shareholders' protection. These principles together have been regarded as the cornerstone of derivative actions. As a result, although the application and the development of these principles in England are not satisfactory and the English law has been regarded as outdated, English law is still the starting point for our understanding of derivative actions. Recent reform of derivative actions in England also shows the trend in the development of derivative actions.

1.5.2.2 The United States

The derivative action is more popular in the United States than in any other country, and the American rules on derivative actions are generally regarded as sophisticated and well developed. Therefore, the American law on derivative actions provides a good model for our study.

The development of the American law shows how American law drew on rules from other countries and how it has adjusted to the tension between corporate efficiency and shareholder protection. This development may be divided into four stages.[40] In the first stage, which occurred in the first part of the nineteenth century, the American rules developed independently without influence from other countries.[41] Coincidently, some principles that were recognized in English law were also acknowledged by American courts at that time. For example, the court, on the one hand, generally recognized the proper plaintiff principle; on the other hand, the court would not allow a wrong to go unredressed simply due to the reason of form, and therefore the right of an individual shareholder to bring a derivative action was basically recognized.[42] In addition, there was an understanding that the minority should first make a demand on the directors for redress before coming to the court.[43] However, unlike the English law, the American law did not generally develop the principle of non-judicial interference in internal

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39 I refer to English law rather than UK law because the Scottish law of derivative actions is different from English and Welsh law.

40 For a detailed discussion of this development, see Section 3.1.1.

41 Boyle (1965), pp. 320-323.

42 Boyle (1965), pp. 320-323.

43 Boyle (1965), pp. 320-323.

matters, and no majority shareholders' power existed to ratify the misconduct which minorities complained of.[44] It was not until the 1870s that these principles from English law were introduced into American law.[45] This could be seen as the start of the second stage of the development. Instead of copying English law, American law borrowed ideas from English law while keeping its own formalities and approach such as the demand requirement.[46] In fact, the American rules were a mixture of 'native' rules and the borrowed English rules. This way of incorporating English rules led to differences between English and American law, even after the introduction of these principles.

Although the introduction of the English *Foss* rule had the effect of tightening American law on derivative actions, for a long time American law still took a lenient approach towards the derivative action; this lenient approach inevitably led to its abuse. As a result, mechanisms to control derivative actions were introduced in the 1940s and the 1970s, and these represent the third and the fourth stages of development.

1.5.2.3 Germany

German law also provides an interesting model for our study. As we know, the German law on corporate governance is famous for its own features, such as the two-tier system of corporate bodies. Nevertheless, recent reforms of German corporate governance are showing a trend toward learning from common law countries.

The German law on derivative actions has also gone through significant changes recently. Before the introduction of the UMAG[47], there was no derivative action in the common law sense. Nevertheless, the former German law did provide an equivalent solution to the issue of enforcing corporate claims by minority shareholders: it allowed a group of minority shareholders to cause the injured company to sue for damages. However, the UMAG has since changed the traditional German law and has introduced a real common law derivative action: the minority shareholders can enforce corporate claims in their own names. In addition, the UMAG also learned from common law countries how to keep a fair balance between corporate efficiency and protection of the company and minority shareholders. For example, it granted the court the power to decide whether to allow a derivative action, and it also introduced a statutory business judgment rule. Nevertheless, the UMAG has still kept the traditional German feature that

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44 Boyle (1965), p. 323.
45 Boyle (1965), p. 323.
46 Boyle (1965), p. 317.
47 The full name of the UMAG is Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts, which means the German Act Regarding Integrity of Companies and Modernizations of Shareholder Suits. For a discussion of the UMAG, see Section 4.1.2.2.

the minority shareholders' right to enforce corporate claims is a group right rather than an individual right, as is the case in the Anglo-American approach.

1.5.2.4 China

The main purpose of this book is to provide suggestions on how to improve the Chinese law on derivative actions on the basis of a comparative study. Although Chinese courts have accepted derivative actions in its judicial practice since the middle of the 1990s, there were no statutory regulations on the derivative action until article 152 of Company Law 2006. Since China has a tradition of civil law, this lack of legislation concerning the derivative action caused practical problems such as inconsistency of judgments and unpredictability of the law. The introduction of the derivative action in Company Law 2006 is expected to solve these problems.

Article 152 of Company Law 2006 is the result of transplantation and obviously bears the traces of the rules from other countries. However, will article 152 play the anticipated role? Considering the special situation found in China, along with the problems that article 152 and other related regulations have had in Chinese law, the answer may be negative. Therefore, this book will try to identify these problems and to provide suggestions for how the Chinese law can be improved.

1.6 The structure of the comparative study

1.6.1 The structure of the book

This comparative study will be conducted on a country-by-country basis. Although some specific regulations on the derivative action are different in the countries cited, the main issues concerned are similar. As a result, the study of the law for each country will follow the same structure. The common issues concerning derivative actions will first be set out and each country's solutions to these issues will be studied. Therefore, this book will be structured as follows. Chapter 1 is the 'Introduction,' providing basic knowledge of the derivative action and the methodology used in this book. Chapters 2, 3, 4 and 5 will be entitled 'England,' 'the United States,' 'Germany' and 'China' respectively. They will be followed by Chapter 6, the 'Conclusion.'

1.6.2 The scope of the comparative study

Derivative actions involve many issues both in the area of company law and civil procedure law. However, this book will not be discussing the issues merely in terms of civil procedure law such as the issues of the company's position in the procedure, of *res judicata*, and of the court's jurisdiction. Instead, this book will focus on the issues arising from company law. Of course, some procedural issues

will perforce be discussed since they are related to the company law issues. In addition, this book will not discuss the situation where the company is in bankruptcy; it will, instead, only be concerned with the company as a going concern.

In studying the law of derivative actions in each country, we will focus on the following issues.

First of all, a basic introduction to the law for each country will be given. This will include the background of the law, the basic rules for derivative actions and the reforms of those rules where applicable.

The second part will discuss the role of the derivative action and the reasons for this role in each country. In order to understand this role better, some alternative mechanisms to the derivative action will also be briefly discussed.

The third topic will be how to distinguish shareholders' derivative actions from shareholders' direct actions. As mentioned[48], the shareholder's right of derivative actions derives from the company's right of action. Where the cause of action lies in the company, the plaintiff shareholder must bring a derivative action and satisfy the restrictions of a derivative action. However, if the shareholder's personal interests have been infringed, he can bring a direct action for remedies such as damages, injunction or an exit right without being subject to these restrictions. Thus, it is essential to distinguish shareholders' derivative actions from shareholders' direct actions. Nevertheless, it is not always easy to make such a distinction, especially in close companies. As will be observed, the major criterion for making a distinction is the 'right' and/or 'injury' criterion, but a more flexible approach has also been taken, such as that found in American law.

The fourth issue will be how to strike a fair balance between corporate efficiency and protection of the interests of companies and minority shareholders. On the one hand, it is generally acknowledged that there should be only limited judicial intervention in corporate management. This is supported by various basic assumptions. To begin with, it is founded on the general policy of *laissez-faire*. A society governed by the court is not desirable. Second, the court is not an expert on business matters, and so it is not considered fair for the court to make a judgment on business matters *ex post*. Third, a full review of management decisions may lead to a situation of excessive risk-avoidance by boards, or even paralysis of boards. Normally a decision to turn down a business opportunity is less likely to be criticized than a decision to follow up on a business opportunity, especially since business opportunities normally come with risks attached. Fourth, if directors are unreasonably burdened with liabilities caused by their business decisions, they will invest their human capital in other fields or charge more for their services. As a result, the cost of human capital in a company will be much higher which will be disadvantageous to the company. On the other

48 See Section 1.1.

hand, the minority shareholders' interests should be protected. The corporate operators, the majority shareholders and/or the directors, may abuse their power and infringe the company's interests and minority shareholders' interests indirectly. Therefore, how to strike a fair balance between them is a pivotal but difficult issue.

Although the countries we will study take different approaches towards creating a balance in derivative actions, the basic methods for setting this balance are similar. Therefore, the study on how a fair balance is struck in each country will mainly discuss the methods used. Since the most important method is usually to place certain restrictions on the minority shareholder's right to derivative actions, our study will start with these restrictions. I will first discuss the substantive restrictions. As mentioned, it is generally acknowledged that corporate management should not be unjustly interfered with. This consideration is twofold. On the one hand, minority shareholders should not inappropriately interfere with the board's daily business operations. Therefore, the minority shareholders may not challenge conduct which is merely business judgment. On the other hand, since a corporate litigation decision is also a business decision and generally falls within the board's power, the non-interference consideration should also apply to the board's litigation decision. This first aspect generates the issue of what kind of misconduct may lead to derivative actions, while the second generates the issue of who the derivative action may be initiated against. The substantive restrictions mainly include these two issues.

Second, I will discuss those procedural restrictions such as the standing requirements on the plaintiff shareholders and the procedures for bringing a derivative action. In fact, as will be observed, Chinese law mainly focuses on these procedural restrictions but neglects other methods for striking a balance. This may end up causing problems in practice.

Third, the effect of the independent body's point of view regarding the corporate litigation decision will be studied. As will be seen, the independent body's decision not to sue may prevent a derivative action.

The fourth part will discuss how each country solves the problem of the plaintiff's incentive to bring a derivative action. As mentioned, minority shareholders can have an under-incentive or an over-incentive problem when initiating derivative actions. These problems will also affect the function of the derivative action itself. Although several factors will affect the shareholders' incentive, most of them are financial since investors are basically looking for profits. Mechanisms taken by various countries to deter or encourage shareholders' incentives are, therefore, mainly financial, such as reducing the plaintiff shareholder's burden of litigation costs.

The fifth method for striking a balance is by limiting directors' financial exposure to the risks and costs of litigation. This is an important method in the United States where it is rather common to hold directors liable. However, as will be observed, this method is less important in other countries, such as England and Germany, where directors are rarely held liable. We should also note that where

loss of reputation is regarded as worse than financial loss, such a limitation may not provide sufficient protection for the defendant directors.

Of course, we should bear in mind that these methods for striking a balance are not exclusive; other ways such as improving the minority shareholders' right to information are also important.

It goes without saying that a comment will follow each comparative study. '[M]erely to juxtapose without comment the law of the various jurisdictions is not comparative law: it is just a preliminary step.'[49] Therefore, after the discussion of how to strike a fair balance, the study of each country will end with a conclusion.

49 Zweigert & Kötz (1998), p. 43.

Chapter 2

England

2.1 Introduction to English law on derivative actions

2.1.1 Overview

Derivative actions in England have traditionally been regulated by the famous *Foss v. Harbottle*[1] rule and by developments in this rule. According to these common law rules, an individual shareholder can bring a derivative action in exceptional situations. Nevertheless, there are many criticisms surrounding the common law derivative action. To name a few, the *Foss* rule is very complicated and is also unstable. It has kept on developing ever since its origins in *Foss v. Harbottle* in 1843, after which the rule is named, and not all the decided cases have necessarily been reconciled with each other.[2] In fact, it is very difficult to define what exactly the *Foss* rule is. People actually regard the rule as the 'deepest mystery of company law'.[3] In addition, it scarcely provides minority shareholders with any effective mechanism to protect themselves or the company, or to discipline corporate management. In England, universities have even given up teaching the *Foss* rule.[4] Due to these problems with the common law derivative action, reforms aimed at a new statutory derivative action have been suggested and a new statute introducing statutory derivative action is expected to be effective soon.[5]

In addition to the common law derivative action, the Companies Act 1985 also includes several articles that provide minority shareholders with the right to bring derivative actions in certain cases. For example, section 461(2)(c) provides that if a petitioner successfully proves unfair prejudice, the court may '... authorize civil proceedings to be brought in the name and on behalf of the company by such person or persons and on such terms as the court may direct ...'. Section 347I also grants a statutory derivative action in cases of political donations or expenditures

1 (1843) 2 Hare 461.
2 Davies (2003), p. 458.
3 Mayson et al. (1996), p. 531.
4 Sealy (1997), p. 180.
5 For the proposals for these reforms, see Section 2.1.5.2; for the contents of these reforms, see Section 2.4.2.

by the company.[6] However, these derivative actions are not the major concern of this book as special requirements are needed to apply them.

2.1.2 *The traditional Foss rule: the principles and the exceptions*

2.1.2.1 *Two basic principles of the Foss rule*

The traditional *Foss* rule includes two interrelated principles and several exceptions to these principles. In *Foss v. Harbottle* two principles have been identified: the majority rule principle (the first limb of the rule) and the proper plaintiff principle (the second limb). The proper plaintiff principle has been widely accepted and regarded as a cornerstone of modern company law. Nevertheless, the majority rule principle is complex, vague and controversial. In fact, the disputes about the *Foss* rule are mainly about the majority rule principle. In the following sections I will be discussing these principles in detail.

The proper plaintiff principle

The proper plaintiff principle was first stated by Sir James Wigram VC in *Foss v. Harbottle*. With regard to the wrongs done to the company, 'the corporation should sue in its own name and in its corporate character, or in the name of someone whom the law has appointed to be its representative'.[7] On the other hand, of course, where the wrong was done to an individual shareholder, the individual shareholder could bring a direct action for his personal injury. In fact, this principle is based on the acknowledgement that the rights of a company are different from those of its shareholders.

English law also recognizes a related principle by which a shareholder cannot claim for losses simply reflective of the corporate losses; he can only claim for his losses, which are separate and distinct from those corporate losses.[8] This 'no reflective loss' principle was clearly stated in *Prudential Assurance Co. Ltd. v. Newman Industries Ltd. (No. 2)* (the Court of Appeal).[9] In this case, the Court of Appeal held that where the only loss suffered by the individual shareholder was a diminution in the value of shares resulting from the company's losses, there could be no claim for this diminution in a personal action because no personal loss was

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6 Part XA (sections 347A to 347k) of the Companies Act came into force in 2001. However, Companies Bill (218) suggests abolishing this type of derivative action.

7 (1843) 2 Hare 461, p. 491.

8 Of course a critical problem with the principle is the difficulty in distinguishing the reflective loss and the independent and separate loss. See Davies (2003), p. 456.

9 [1982] Ch. 204. For a detailed discussion of the development of this principle, please refer to, for example, Mukwiri (2005); Mitchell (2004); Hirt (2003b); and Ferran (2001).

suffered in such cases; the loss was that of the company and the shareholder's loss was only reflective of the company's losses.[10]

However, as we will see later, through a pragmatic application of the statutory unfair prejudice petition, English law actually takes a flexible approach towards the proper plaintiff principle and the no reflective loss principle.[11]

The majority rule principle

In *Foss v. Harbottle* Sir James Wigram VC also clearly pointed out for the first time that the court would not interfere with an irregularity which the majority shareholders might lawfully ratify.[12] This approach has been subsequently followed and reiterated again and again ever since.[13] In *Edwards v. Halliwell*[14], Jenkins L.J. gave a representative statement, which was regarded as the best description of the principle:[15]

> Where the alleged wrong is a transaction which might be made binding on the company or association and on all its members by a simple majority of the members, no individual member of the company is allowed to maintain an action in respect of that matter for the simple reason that, if a mere majority of the members of the company or association is in favour of what has been done, then *cadit quaestio*.[16]

The majority rule principle has two meanings. First, it treats a simple majority of shareholders as the appropriate body to ratify misconduct and therefore recognizes the collective nature of corporate decisions.[17] Second, it also prevents a minority shareholder from initiating a derivative action if the alleged misconduct is a mere *irregularity* which is *ratifiable* by a simple majority of shareholders; as a general principle, there should be no judicial intervention in business matters.

The origin of the majority rule principle has its own specific background. As we know, *Foss v. Harbottle* was decided at a time when incorporation was not freely

10 [1982] Ch. 204, pp. 222-223.

11 See Section 2.2.2.

12 (1843) 2 Hare 461, at pp. 494-495. Also see Boyle (2002), p. 4. The Law Commission Law also recognizes that both of these principles were applied in the *Foss* case, see Law Commission Report 246 (1997), para. 6.1. However, there is another opinion that in the *Foss* case only the proper plaintiff principle was established, the majority rule principle did not arise until *Mozley v. Alston*, (1847) 1 Ph 790 was decided, see Berkahn (1998), p. 76, Footnote 9.

13 Such as in *Burland v. Earle*, [1902] AC 83; *Edwards v. Halliwell*, [1950] 2 All E.R. 1064; *Prudential Assurance Co. Ltd. v. Newman Industries Ltd. (No. 2)* (the Court of Appeal) [1982] Ch. 204.

14 [1950] 2 All E.R. 1064.

15 See Davies (2003), p. 459.

16 [1950] 2 All E.R. 1064, at p. 1066.

17 Hirt (2004b), p. 71, p. 78, p. 79.

available and 'corporations like this, [statutory companies created by private Act] of a private nature, are in truth little more than private partnerships'.[18] In fact, the decision in *Foss v. Harbottle* relied on early nineteenth-century decisions in the law of partnership.[19] On the one hand, the subordination of the will of the minority shareholder to that of the majority shareholder was not regarded as an injustice because mutual trust and contractual obligations existed between the individual shareholders of this partnership-like company and because these shareholders should have been aware of the consequences when they entered into the company.[20] On the other hand, the court's reluctance to interfere with internal management also has its origins in the partnership principle. According to the partnership principle, the Chancellor would not interfere with internal disputes of the partnership 'except with a view to dissolution'.[21] This non-judicial interference policy protected corporate management against unjust shareholder intervention and encouraged risk-taking to a greater extent. It is understandable, and perhaps justifiable, that the principle was introduced into corporate law in *Foss v. Harbottle*, since the case was decided 'at the height of the industrial revolution'.[22] As a consequence, the decision of *Foss v. Harbottle* 'transformed the old partnership rule into one of the leading principles of modern company law'.[23]

Justifications for the two principles of the Foss rule

There are several justifications for these principles. First, they avoid multiplicity of suits.[24] Without these principles, every shareholder could sue and the company would be faced with multiple lawsuits, especially if troublesome shareholders brought vexatious litigation. Second, these principles, especially the majority rule principle, created a context where futile or wasteful litigation could be avoided.[25] This was clearly explained by Mellish L.J. in *MacDougall v. Gardiner*:

> If the thing complained of is a thing which in substance the majority of the company are entitled to do, or if something has been done irregularly which the majority of the company are entitled to do regularly … there can be no use in having a litigation about it, the ultimate end of which is only that a meeting has to be called, and then ultimately the majority gets its wishes.[26]

Third, the policy reflected in the majority rule principle that the court will not interfere in a mere internal irregularity protects the efficiency of corporate

18 *Foss v. Harbottle* (1843) 2 Hare 461, at p. 491. Also see Berkahn (1998), p. 78; Bottomley (1992), p. 141; Boyle (1965), p. 319.

19 Boyle (1965), pp. 318-319. Also see Berkahn (1998), p. 78; Bottomley (1992), p. 141.

20 Berkahn (1998), pp. 78-79; Bottomley (1992), p. 141.

21 Boyle (1965), pp. 318-319.

22 Berkahn (1998), p. 78.

23 Boyle (1965), pp. 318-319. Also see Berkahn (1998), p. 78.

24 See such as *Gray v. Lewis* (1873) 8 Ch. App. 1035, at p. 1051; Boyle (2002), p. 6.

25 See such as Boyle (2002), p. 7.

management and encourages that fair-business risk-taking necessary for business. It is generally accepted that the court should determine questions of law instead of questions of business judgment.

It is not surprising that there are also doubts about these principles and the justifications for them. For example, Boyle points out that even without the *Foss* rule, a court of equity may still solve the problem of multiplicity of suits.[27] Moreover, the distinction between the interests of the company and those of individual shareholders is not always clear, and furthermore, the majority rule principle may unfairly leave out some meritorious cases and as a result cannot provide sufficient protection to minority shareholders and the company.[28]

2.1.2.2 Exceptions to the Foss rule principles

English courts generally recognize four exceptions to the above-mentioned principles, although in our view not all of them are true exceptions. These are the personal rights exception, the illegal or *ultra vires* acts exception, the special majority exception, and the fraud exception. In *Edwards v. Halliwell*, a fifth exception of justice was suggested but this is not generally accepted by later courts.[29] I will discuss these exceptions briefly in the following sections.

2.1.2.2.1 The 'personal rights' exception

The 'personal rights' exception means that where the misconduct infringes the personal rights of a shareholder, the shareholder can redress his damage by initiating a direct action. Since this exception actually describes a situation where the *Foss* rule simply has no application, it is not a true exception.

The problem with this so-called exception may simply lie in the difficulty of making a clear distinction between corporate interests and a shareholder's personal interests. I will discuss this issue in Section 2.3.

2.1.2.2.2 The 'illegal or *ultra vires* acts' exception and the 'special majority' exception

The *Foss* rule principles will not apply to illegal acts or *ultra vires* acts before 1989 since they simply cannot be ratified; nor will they apply to misconduct

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26 (1875) 1 Ch. D. 13, at p. 25.

27 Boyle (2002), pp. 6-7.

28 Boyle (2002), p. 7.

29 See *Edwards v. Halliwell* [1950] 2 All E.R. 1064, p. 1067, where it was suggested that the *Foss* rule should not be applicable in such situations where necessary 'in the interests of justice.' However, later cases such as *Estmance (Kilner House) Ltd. v. Greater London Council* [1982] 1 W.L.R. 2 and *Prudential Assurance Co. Ltd. v. Newman Industries Ltd. (No. 2)* (the Court of Appeal), [1982] Ch. 204 did not follow *Edwards v. Halliwell*, see Law Commission CP 142 (1996), para. 4.7, Footnote 17.

which needs to be validly committed or ratified by only a special majority of shareholders because a simple majority of shareholders cannot confirm or ratify a transaction which needs a greater majority.[30] The former exception is called the 'illegal or *ultra vires* acts' exception and the latter the 'special majority' exception.

Since the reforms of 1989, *ultra vires* acts can be ratified by a special majority shareholders' resolution[31], except for those that are patently illegal.[32] In this sense, it may be better to treat the *ultra vires* exception as already being included nowadays in the special majority exception.[33]

2.1.2.2.3 The 'fraud on the minority' exception

The 'fraud on the minority' exception is regarded as the only 'true' exception to the *Foss* rule.[34] The meaning of the 'fraud on the minority' exception and the justification for the exception was well illustrated in *Prudential Assurance Co. Ltd. v. Newman Industries Ltd. (No. 2)* (the Court of Appeal):

> (5) There is an exception to the [*Foss*] rule where what has been done amounts to fraud and the wrongdoers are themselves in control of the company. In this case the rule is relaxed in favour of the aggrieved minority, who are allowed to bring a minority shareholders' action on behalf of themselves and all others. The reason for this is that, if they were denied that right, their grievance could never reach the court because the wrongdoers themselves, being in control, would not allow the company to sue.[35]

We should note here, however, that the wrong was actually done to the company rather than to the individual shareholders; therefore the exception may in fact be misnamed.

As mentioned in *Prudential Assurance Co. Ltd. v. Newman Industries Ltd. (No. 2)* (the Court of Appeal), two requirements must be met in order to satisfy the exception: the existence of a 'fraudulent' act and the existence of wrongdoer control. Regretfully, neither of these requirements is clear under English law.

The 'fraud' requirement

'Fraud' here has a wider meaning than the common sense of deceit. In order to amount to 'fraud,' the wrongdoer must commit deceit (or be dishonest, thus the

30 See, for example, *Prudential Assurance Co. Ltd. v. Newman Industries Ltd. (No. 2)* (the Court of Appeal), [1982] Ch. 204, at 210F-211B.
31 Companies Act 1985, section 35(3), as amended by Companies Act 1989, s. 108(1).
32 Morse (1991), p. 442.
33 Morse (1991), p. 442.
34 See, for example, Law Commission CP 142 (1996), part 4, Footnote 13.
35 [1982] Ch. 204, at p. 211.

common understanding of the term 'fraud'), or benefit himself at the expense of the company.[36] The mere fact of improper purpose, lack of *bona fide*, conflict of interest, or simple negligence is not sufficient.[37] In *Pavlides v. Jensen*[38], the plaintiff's action was rebutted because the defendant directors had not benefited from their own negligence and thus no fraud was found. In addition, if the wrongdoer benefited from his breach of duties, but not at the expense of the company, no derivative action may be initiated against him either. This opinion is supported by the *dicta* of the House of Lords in *Regal (Hastings) v. Gulliver*[39], where the wrongdoer was regarded as merely making an incidental profit rather than misappropriating the company's property.[40]

However, there are criticisms of the fraud requirement. First, the standard of fraud is not as easy to apply as it seems. The major reason is the difficulty in defining corporate properties. In *Cook v. Deeks*[41], where the wrongdoing directors acquired for themselves the contracts which they should have acquired on behalf of the company, a fraud was found because the directors' acquiring of the contracts was a misappropriation of corporate property. However, in the above-mentioned case of *Regal (Hastings) v. Gulliver*, where the directors made use of the information they received as directors and benefited from that use, it was held that there was no fraud because the directors only took advantage of a corporate opportunity which the company could not itself use and so no corporate property was misappropriated. In fact, the distinction between fraudulent acts and non-fraudulent acts has never clearly been settled under English law. Second, the requirement of a fraudulent act is also criticized for its restricted scope. As mentioned above, a wide range of wrongdoer's misconduct may not be regarded as fraud and therefore no derivative action may be brought against it. If the wrongdoer controls the company and prevents the company from suing against the non-fraudulent misconduct, the company may simply have no relief.

Fortunately, these criticisms have been widely acknowledged and reforms of the derivative action already take them into account. As will be seen in Section 2.4.2.2.2, the Companies Bill abolishes this requirement and extends the application of derivative actions to the breach of any director's duty.

The 'wrongdoer control' requirement

Traditionally, English courts have required that the plaintiff shareholder should establish that the company was controlled by the wrongdoer before he is allowed

36 This wider definition of 'fraud' was not introduced until *Daniels v. Daniels*, [1978] Ch. 406, 414A-E; [1978] 2 All E.R. 89. *Daniels* was followed by later courts.

37 Davies (2003), pp. 440-441.

38 [1956] Ch. 565.

39 [1942] 1 All E.R. 378, at 382F and 389D-E; Hollington (1999), p. 20.

40 Davies (2003), pp. 439-440.

41 [1916] 1 A.C. 554, PC.

to continue a derivative action.[42] The reason for this requirement is that English law traditionally recognizes that the company's fair collective decisions, especially decisions concerning ratification or decisions not to sue made by the general meeting of shareholders, are preferable to any individual shareholder's derivative actions. As a result, in order for him to bring a derivative action, a plaintiff shareholder has to establish that such a fair collective decision cannot be reached because the wrongdoer controls a majority of the shareholders' voting rights. As will be observed, this preference for the collective nature of corporate decisions is an important feature of English law and has been further developed in *Smith v. Croft (No. 2)*.[43]

However, the 'wrongdoer control' requirement also has problems. First of all, it may leave certain wrongs unredressed. For example, where the wrongdoer does not control the general meeting but prevents the submission to the general meeting of the issue complained of, the wrong still might not be redressed because the general meeting simply has had no chance to consider it. In such circumstances, no derivative action will be allowed since the 'wrongdoer control' requirement cannot be established.

The second problem with the 'wrongdoer control' requirement is that this strict definition of 'control' may have the effect that the fraud exception will become nearly impossible to apply in public companies. In *Prudential Assurance Co. Ltd. v. Newman Industries Ltd. (No. 2)* (the Court of Appeal), the Court of Appeal held that the term of control:

> ... embraces a broad spectrum extending from an overall absolute majority of votes at one end, to a majority of votes at the other end made up of those likely to be cast by the delinquent himself plus those voting with him as a result of influence or apathy.[44]

Although in this case the Court of Appeal rejected the stricter *de jure* control approach found in *Pavlides v. Jensen*, which required that the wrongdoers own directly or through nominees at least fifty-one percent of the voting shares[45], it still held that the *de facto* control of more than fifty percent of votes needed to be proved.[46] This could cause a severe problem in the case of public companies.

42 Law Commission CP 142 (1996), para. 4.12.
43 [1988] Ch. 114. For a detailed discussion, see Sections 2.1.3.3 and 2.4.1.3.
44 [1982] Ch. 204, p. 219. Apathy includes, for example, the votes afforded to the directors by the proxy voting system; see Davies (2003), p. 461.
45 See Boyle (2002), p. 27.
46 See Law Commission CP 142 (1996), para. 4.16.

2.1.2.2.4 The 'interest of justice' exception

Edwards v. Halliwell suggested that the *Foss* rule should not be applicable in situations where this was necessary in the interests of justice.[47] However, this exception has not been generally accepted by English courts because it has been considered 'not a practical test'.[48] Therefore, there is no point in any further discussion of this exception here.

2.1.2.3 Comments on the traditional Foss rule

The traditional *Foss* rule has established two basic principles of company law and several exceptions to these principles. It has also raised the difficult question of striking a balance between corporate efficiency and protection of the company and minority shareholders. On the one hand, derivative actions are necessary in order to protect the interests of the company and minority shareholders; on the other hand, they should also be restricted in order to protect corporate efficiency.

The *Foss* rule has favored corporate efficiency over protection of the company and minority shareholders. Under this rule, derivative actions are strictly limited. The major method in this limitation is the *ex ante* restriction as to the nature of the misconduct that may give rise to derivative actions. According to the *Foss* rule, a derivative action is only allowed where there is illegal or *ultra vires* conduct, an act in breach of a special majority or procedural requirement (the special majority situation), or a fraudulent act. Since these acts are regarded as non-ratifiable by a simple majority of shareholders under English law, this approach is also called the 'non-ratifiable' wrong theory. This restriction of derivative actions to 'non-ratifiable' wrongs has both advantages and disadvantages. On the one hand, the *ex ante* restriction of derivative actions prevents minority shareholders from unjustly interfering with corporate management and provides protection for corporate managers; moreover, an *ex ante* regulation has the advantage of clearness and certainty.[49] However, on the other hand, it also has its problems. For example, due to the narrow scope of non-ratifiable wrongs identified by the common law, as well as the requirement of wrongdoer control, the *ex ante* restriction may not provide sufficient protection for the company and minority shareholders. In addition, the vague boundary between ratifiable and non-ratifiable wrongs devalues the advantage of the certainty of law.

The traditional *Foss* rule also requires the plaintiff shareholder to prove 'the wrongdoer control' aspect in the fraud exception. This requirement reflects the

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47 [1950] 2 All E.R. 1064, p. 1067.

48 *Prudential Assurance Co. Ltd. v. Newman Industries Ltd. (No. 2)* (the Court of Appeal), [1982] Ch. 204, p. 221. However, Vinelott J. had accepted this exception in the first instance, [1981] Ch. 257. For the approach of rejection of the exception, also see *Estmance (Kilner House) Ltd. v. Greater London Council* [1982] 1 W.L.R. 2.

49 Ferran (1998), pp. 235-247.

English approach of safeguarding the collective nature of corporate decisions and has been extended to all derivative actions since.[50]

2.1.3 Development of the Foss rule

2.1.3.1 Prudential Assurance Co. Ltd. v. Newman Industries Ltd. (No. 2) (the Court of Appeal): the Foss rule as the locus standi requirement as well as the substantive requirement for derivative actions

For a long time there has been confusion as to when the requirement of the *Foss* rule should be raised during the procedure of a derivative action. In most cases the issue has been determined to be a preliminary one, while in some cases it has been left to be decided at a full-trial hearing.[51] This issue was not resolved until the leading case of *Prudential Assurance Co. Ltd. v. Newman Industries Ltd. (No. 2)*. In the first instance of *Prudential*, Vinelott J. dismissed the defendants' application that it should be decided as a preliminary issue whether the plaintiff was able to bring a derivative action.[52] However, the Court of Appeal rejected Vinelott J.'s approach and insisted that the issue should be decided as a preliminary one.[53] In this case, the Court of Appeal raised the famous requirement that in order to bring a derivative action the plaintiff shareholder must '… establish a *prima facie* case (i) that the company is entitled to the relief claimed and (ii) that the action falls within the proper boundaries of the exception to the rule in *Foss v. Harbottle*'.[54] Accordingly, the *Foss* rule not only provides a substantive restriction on the shareholder's right to a derivative action, but also serves as a procedural restriction by determining whether a shareholder has *locus standi* to bring a derivative action.[55]

This standing requirement of the *Foss* rule under the Court of Appeal case of *Prudential* nevertheless makes it difficult for a shareholder to bring a derivative action: the shareholder has to *prima facie* pass the *Foss* rule test. In addition, it is also difficult for the judges to decide whether the plaintiff has the standing to sue in the very early stages of a proceeding because there is hardly any evidence available to them.[56] Although the Court of Appeal in the *Prudential* case considered that the preliminary stage on the *locus standi* issue should be short[57],

50 See Section 2.1.3.2.
51 Such as *North-West Transportation Co. Ltd. v. Beatty* (1887) L.R. 12 App. Cas. 589 (PC); *Hogg v. Cramphorn Ltd.* [1967] Ch. 254; also see Boyle (2002), p. 8.
52 [1981] Ch. 257, pp. 286-287.
53 [1982] Ch. 204, pp. 221-222.
54 [1982] Ch. 204, pp. 221-222.
55 Boyle (2002), p. 8; Davies (2003), p. 453.
56 Sealy (1987), p. 4.
57 [1982] Ch. 204, pp. 221-222.

this might not always be the case.[58] The court may have to decide complicated questions of law or questions of fact or both.[59]

2.1.3.2 *Taylor v. National Union of Mineworkers (Derbyshire Area): generalization of the 'wrongdoer control' requirement*[60]

Taylor v. National Union of Mineworkers (Derbyshire Area)[61] extended the 'wrongdoer control' requirement in the fraud exception to encompass all derivative actions, including those against illegal or *ultra vires* acts, or acts which need a special majority's ratification. This generalization of the 'wrongdoer control' requirement is based on the court's recognition that the simple majority shareholders' power to make a negative litigation decision against any misconduct (the decision not to sue) differs from their power to ratify the misconduct: although a simple majority of shareholders cannot ratify non-ratifiable misconduct, they may still be capable of deciding whether to sue against this non-ratifiable misconduct in the name of the company. If they decide not to sue, this negative litigation decision should bar the individual shareholder's right to derivative actions, unless the wrongdoer controls the voting and therefore a fair litigation decision cannot be made. As a result, the individual shareholder needs to establish 'wrongdoer control' before being allowed to continue the derivative action.

It is obvious that *Taylor* regarded a majority of shareholders to be more appropriate than individual shareholders for making litigation decisions on behalf of the company. This was well elucidated by Vinelott J.:

> Although the misapplication of the funds of a corporate body ... cannot be ratified by any majority of the members, however large, it is open to a majority of the members, if they think it is right in the interests of the corporate body to do so, to resolve that no action should be taken to remedy the wrong done to the corporate body and such a resolution, if made in good faith and in what they considered to be for the benefit of the corporate body, will bind the minority.[62]

By extending the wrongdoer control requirement to all derivative suits, *Taylor* actually followed and developed the approach of favoring the collective nature of

58 For example, the hearing of *Smith v. Croft (No. 2)* [1988] Ch. 114 lasted 18 days; see Law Commission CP 142 (1996), para. 6.6. In that case complicated questions of law arose. Difficult questions of fact can also arise at this stage.

59 Law Commission CP 142 (1996), para. 6.6.

60 For a detailed discussion, see Hirt (2004b), pp. 163-167.

61 [1985] B.C.L.C. 237.

62 *Taylor v. National Union of Mineworkers (Derbyshire Area)* [1985] B.C.L.C. 237, pp. 254-255.

corporate litigation decisions in the tradition of the *Foss* rule.[63] The case was confirmed in *Smith v. Croft (No. 2)*, where the wrongdoer control requirement applied to the *ultra vire* act. This extra restriction on an individual shareholder's right to derivative actions in fact has a negative effect on the function of derivative actions.

2.1.3.3 Smith v. Croft (No. 2): the independent body's view

Smith v. Croft (No. 2) further developed the approach of favoring the collective nature of the corporate litigation decision. In this case Knox J. held that:

> Ultimately the question which has to be answered in order to determine whether the rule in *Foss v. Harbottle* applies to prevent a minority shareholder seeking relief as plaintiff for the benefit of the company is 'Is the plaintiff being improperly prevented from bringing these proceedings on behalf of the company?' If it is an expression of the corporate will of the company by an appropriate independent organ that is preventing the plaintiff from prosecuting the action he is not improperly but properly prevented and so the answer to the question is 'No'.[64]

Smith v. Croft (No. 2) recognized that where a simple majority of shareholders is not available to make a litigation decision in the best interests of the company such as in the case of wrongdoer control, an appropriate independent body is still preferable to an individual shareholder in making such a decision. An individual shareholder is regarded as not being in a better position to sue than the company itself.[65] Consequently, this case has added another restriction to the individual shareholder's right to initiate derivative actions: a negative litigation decision of an appropriate independent body will also bar a derivative action, provided the decision is made in good faith and for the benefit of the company.[66] Therefore, a simple majority shareholders' decision is no longer needed in order to prevent a derivative action. This restriction of an independent body's view applies 'equally to frauds and to corporate actions arising out of *ultra vires* cases'.[67]

With regard to the practical application of this new development in *Smith v. Croft (No 2)*, there are still several unsettled issues, which I will discuss in Section 2.4.1.3. Nevertheless, it is important to indicate here that the new development has actually put a significant restriction on the individual shareholders' right to derivative action and therefore 'will have a destructive impact upon the derivative action' if it is followed.[68]

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63 Hirt (2004b), p. 167.
64 [1988] Ch. 114, at p. 185.
65 Davies (2003), p. 465.
66 See Mayson et al. (1996), p. 538.
67 Davies (2003), p. 462.
68 Davies (2003), p. 462.

2.1.3.4 *Comments on the development of the Foss rule*

The case law development of the *Foss* rule has shown a trend toward tighter restrictions on a shareholder's right to derivative actions. In *Prudential Assurance Co. Ltd. v. Newman Industries Ltd. (No. 2)* (the Court of Appeal), the *Foss* rule served as a prerequisite standing requirement for a shareholder to initiate a derivative action; *Taylor* extended the 'wrongdoer control' requirement in the fraud exception to all derivative actions; and *Smith v. Croft (No 2)* added the most significant restriction since the *Foss* rule, ruling that the individual shareholder's right to derivative actions should be submitted to an independent body's review. This trend shows that English courts have undervalued the function of derivative actions. In fact, 'the derivative action is not to be regarded as a normal part of the enforcement apparatus of the law, but as a weapon of last resort'.[69]

2.1.4 *Rule 19.9 of the Civil Procedure Rules: the requirement of judicial approval to continue a derivative action*

Rule 19.9 of the Civil Procedure Rules stipulates the procedures for bringing a derivative action. In 1994, Rules of the Supreme Court (Amendment) 1994 (RSC) Ord. 15, r. 12A, which specifically dealt with derivative actions, came into force. This rule has now been replaced by a simplified form of the new Civil Procedure Rules 1998, part 19, rule 19.9, as amended by the Civil Procedure (Amendment) Rules 2000. The latter came into force as of May 2, 2000. The major characteristic of rule 19.9 is that it requires that the plaintiff shareholder seek leave from the court to continue a derivative action.[70] Nevertheless, it does not clarify the factors that the court should take into account when deciding whether to grant leave. For a detailed discussion of rule 19.9, see Section 2.4.1.2.3.

2.1.5 *Reforms of the common law derivative action*

2.1.5.1 *The necessity for reforms*

The English law on derivative actions, as mentioned above, is regarded as obscure, complex and 'inaccessible save to lawyers specializing in this field'.[71] Moreover, those cases already decided have not been reconciled with each other.[72] It has been widely acknowledged in England that there should be reforms to common law derivative action.[73]

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69 Davies (2003), p. 463.

70 CPR, part 19, rule 19.9(3).

71 For comments on the current law, see Law Commission Report 246 (1997), paras. 1.4, 1.6, 6.4, 7.11. Also in Law Commission CP 142 (1996), paras. 1.6, 14.1-14.4.

72 Davies (2003), p. 458.

73 See Law Commission Report 246 (1997), executive summary.

Reforms to the common law derivative action are also regarded as a necessity in order to keep up with the international trend. After reviewing recent developments in other countries, such as Canada, Australia, New Zealand, Hong Kong and Japan, the Law Commission recognized that 'In an age of increasing globalization of investment and growing interest in corporate governance, greater transparency in the requirements for a derivative action is in our view highly desirable'.[74]

2.1.5.2 *Proposals for the reforms*

The Law Commission has carried out the primary reform work on derivative actions. In February 1995, the Lord Chancellor and the President of the Board of Trade requested the Law Commission '... to carry out a review of shareholder remedies with particular reference to: _ the rule in *Foss v. Harbottle* (1843) 2 Hare 461 and its exceptions; sections 459 to 461 of the Companies Act 1985; and the enforcement of the rights of shareholders under the articles of association; and to make recommendations'.[75] The Law Commission published its Consultation Paper in 1996 and the Report in October 1997 respectively, where recommendations for a new statutory derivative action were made.[76]

In March 1998, the Department of Trade and Industry (the DTI) of the UK launched a three-year project to review the whole of British core company law, including shareholder remedies. An 'independent, widely based, non-political' Company Law Review Steering Group (referred to hereafter as 'the CLR')[77], whose members were appointed by the DTI, conducted this project. The project broadly fell into four stages: strategy, development, completion, and final phases. At each stage a consultation document was published. These documents, with the common heading of *Modern Company Law for a Competitive Economy*, are named respectively, *The Strategic Framework*, *Developing the Framework*, *Completing the Structure*, and *The Final Report*.[78] Following the CLR's reports, two White Papers on company law reform were published in 2002 and 2005 respectively[79], which set out the Government's proposals for the comprehensive reform of British company law.[80] Consequently, the Company Law Reform Bill was introduced in the House of Lords on November 1, 2005, and brought forward to the House of Commons on May 24, 2006. On July 20, 2006 the Bill completed the Commons Committee. The title of the 'Company Law Reform Bill' was changed to the 'Companies Bill' during the committee stage in the House of

74 Law Commission Report 246 (1997), para. 6.9.
75 See Law Commission CP 142 (1996), para. 1.2.
76 Law Commission CP 142 (1996), section B; Law Commission Report 246 (1997), part 6.
77 See Rickford (2002), at p. 9.
78 They were published respectively in February 1999, March 2000, November 2000, and July 2001. For a detailed review of the reform, see Rickford (2002).
79 White Paper (2002) and White Paper (2005).
80 White Paper (2005), Summary, p. 5.

Commons in July 2006.[81] On October 19, 2006 the Bill completed the Report and Third Reading stages of the House of Commons. As a result, a new company act is expected to come into force in the near future. As to the reform of derivative actions, both the CLR and the Companies Bill basically endorse the Law Commission's recommendations but with several differences. I will discuss the recommendations for the new statutory derivative action in Section 2.4.2.

2.2 The role of derivative action in England

2.2.1 An unimportant role and the reasons for it

Common law derivative action actually plays an unimportant role in English practice in disciplining corporate management and in protecting the interests of the company and minority shareholders, especially in public companies. Minority shareholders' derivative claims against wrongdoers are rare, particularly since the new developments in the *Foss* rule.[82] Some factors may account for this unimportant role.

Strict requirements

The *prima facie* reason for the rare application of common law derivative actions is the increasingly strict requirements under English law for initiating a derivative action. These strict requirements make it difficult even to have a chance of a hearing. Professor Sealy pointed out that in England:

> . . . the rule has been formulated and applied in a progressively more and more restrictive way to the point where it would now be either a very bold or a very foolish lawyer who would allow or encourage his shareholder client even to think of starting derivative action.[83]

English policies

These strict requirements actually reflect the traditional English attitude towards derivative action and the policies behind it. First, English courts have traditionally been reluctant to interfere with corporate internal management. Professor Sealy regards this attitude of non-judicial interference as the major reason that English law has put strict requirements on initiating derivative actions, even though it may

81 The latest version of the Companies Bill is Bill 218 (20 July 2006, House of Commons). For details of the Companies Bill, see http://www.dti.gov.uk/bbf/co-law-reform-bill/index.html.

82 Hirt (2004b), p. 18; Sealy (1987), p. 1.

83 Sealy (1997), p. 179.

not explicitly say so.[84] As to the balance between the efficiency of corporate management and protection of minority shareholders, English law has consistently favored the former.

Second, the development of English law has shown 'a marked judicial antipathy, even hostility, towards the minority shareholder who comes before the court as a litigant'.[85] This judicial antipathy is even more obvious towards minority shareholders in large public companies because such companies are of enormous size and play important roles in the economy, and because the minority shareholders therein normally have less of a stake in bringing a derivative action.[86] Actually, English common law has consistently been more concerned with the risk of the abusive application of derivative actions by minority shareholders than with the risk of insufficient protection for the company and minority shareholders.[87]

Third, English common law has insisted on the collective nature of corporate decision-making: an individual shareholder's derivative action should be subjected to an appropriate collective decision-making body. Therefore, the derivative action becomes a last resort.[88] With regard to the balance between preserving the collective nature of corporate decision-making and the enforcement of directors' duties and protection of minority shareholders, English law again favors the former.[89]

It is generally agreed that these traditional English policies were based on their specific backgrounds. As we mentioned in Section 2.1.2.1, the *Foss* rule had its origins in partnership principles and was decided at a time when economic development was the main concern. However, we may wonder why, after the 1980s when the context began to change, and especially since protection for companies and investors has begun attracting more and more attention, these policies have not been changed but, instead, have continued to be followed.

Alternative mechanisms

As in other Western jurisdictions, there has been a plurality of legal and non-legal mechanisms to protect companies and minority shareholders, as well as to discipline corporate management in England. For example, in addition to the

84 Sealy (1987), p. 4.
85 Sealy (1987), p. 2.
86 Boyle (2002), pp. 12-13.
87 Davies (2003), p. 447; Hirt (2004b), p. 181.
88 Davies (2003), p. 463. The approach to the derivative action as the weapon of last resort was also embodied in *Barrett v. Duckett*, [1995] 1 B.C.L.C. 243 (CA), where the court found that a derivative action should be allowed only if the plaintiff had no other remedy available; see Section 2.4.1.2.4.
89 Davies (2003), p. 463.

derivative action, the unfair prejudice remedy, the enforcement of shareholders' personal rights, the right to attack the alteration of articles of association, and the just and equitable winding-up remedy also provide private enforcement for individual shareholders. Moreover, English law additionally provides extensive and robust public enforcement of director's duties in order to supplement private enforcement.[90] According to sections 432 (appointment of inspectors) and 447 (investigation of company documents) of the UK Companies Act 1985 (as amended in 1989), the Secretary of State has extensive investigatory and petitioning powers. In addition, market forces such as the takeover mechanism also discipline the behavior of managers, especially those in public companies.

Due to the limitations of this book, it is impossible to discuss all the mechanisms, even if very briefly. However, in the following section I will discuss the unfair prejudice remedy, which is regarded as superseding the derivative action in practice, as well as the relationship of the unfair prejudice remedy to the derivative action.

2.2.2 The unfair prejudice remedy and the derivative action

2.2.2.1 An introduction to the unfair prejudice remedy[91]

2.2.2.1.1 The predominant role of the unfair prejudice remedy

The unfair prejudice remedy, which is provided by sections 459-461 (which will be referred to as the section 459 remedy or the unfair prejudice remedy hereafter) of the Companies Act 1985 (as amended in 1989), was originally introduced because the common law derivative action and the winding-up remedy played an insufficient role in protecting minority shareholders.[92] The intended purpose of enhancing the minority shareholders' position by introducing the unfair prejudice remedy has been achieved to a certain extent. Nowadays the unfair prejudice remedy is, in practice, the major mechanism for providing protection for minority shareholders, especially shareholders in small private companies. It is more popular and more frequently invoked than all the other remedies put together, such as the derivative action, the enforcement of shareholders' personal rights, the right to attack the alteration of articles of association and the just and equitable winding-up remedy.[93] Due to this remedy, minority shareholders may obtain relief which they might not be able to obtain under other forms of procedure.[94]

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90 Kraakman et al. (2004), p. 117; Davies (2003), p. 467.

91 For details of the unfair prejudice remedy, please refer to, for example, Boyle (2002), Davies (2003), Hollington (1999), Joffe (2000), and Boros (1995).

92 Boyle (2002), p. 90; Law Commission CP 142 (1996), para. 7.11.

93 Sealy (1997), p. 174.

94 Sealy (1997), p. 174.

We should note, however, that the unfair prejudice remedy only plays an important role in small and medium-sized companies. It has hardly ever been applied in public companies[95] because it is difficult to prove the most important element of the petition, 'legitimate expectation,' and also because the remedy awarded under the unfair prejudice remedy usually is not compensation but 'buy-out,' which may not be attractive in public companies.[96]

2.2.2.1.2 The unfair prejudice remedy: a wide-ranging remedy

The unfair prejudice petition provides a wide-ranging remedy for an aggrieved shareholder where the company's affairs 'are being or have been conducted in a manner which is unfairly prejudicial to the interests of its members generally or of some part of its members (including at least himself)'.[97] The court, if satisfied that the petition is 'well founded,' may 'make such order as it thinks fit for giving relief in respect of the matters complained of'.[98]

The wording of section 459 is deliberately wide ranging so that the unfair prejudice proceeding can award protection to minority shareholders in various situations.[99] This flexible approach could be seen in the use of certain terms in section 459. First, the 'interests,' rather than merely the legal rights, of a member are protected.[100] The interests protected by the unfair prejudice remedy are normally recognized as the 'legitimate expectation' of a member.[101] Although

95 Law Commission CP 142 (1996), summary: 'The remedy can be used by shareholders in publicly listed companies but the statistical survey shows that 96% of the claims of this type commenced in 1994 and 1995 related to private companies of which 84% had 5 or fewer shareholders.' Also see Law Commission CP 142 (1996), Appendix E, statistics, Table 1.

96 Boyle (2002), pp. 101-102. For an introduction of the unfair prejudice petition, see Section 2.2.2.1.

97 Section 459(1) of the Companies Act 1985 (as amended by the Companies Act 1989, Schedule. 19, para. 11) states that 'a member of a company may apply to the court by petition for an order under this Part (i.e., Part XVII of the Companies Act 1985, added by the writer) on the ground that the company's affairs are being or have been conducted in a manner which is unfairly prejudicial to the interests of its members generally or of some part of its members (including at least himself) or that any actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial.'

98 Section 461(1) of CA 1985.

99 This flexibility, however, also causes problems by blurring the distinction between the unfair prejudice remedy and the derivative action; for details about this issue, please refer to Section 2.2.2.2.

100 Not all interests of a member are protected by section 459. Under this section, 'interests' should be interests qua member. 'Interests' may also include a member's expectation that he continue to participate in corporate management. See Law Commission CP 142 (1996), paras. 9.18-9.20.

101 For judicial illustration of 'legitimate expectation', see *Re Saul D Harrison & Sons Plc* [1995] 1 B.C.L.C. 14, at pp. 19-20, per Hoffmann L.J; *O'Neill v. Phillips*, [1999] 1 W.L.R. 1092, at p. 1102. Also see Davies (2003), pp. 517-518.

generally no informal agreements are recognized as legitimate expectations in public companies, especially listed companies[102], in private companies, especially small ones, legitimate expectation is generally recognized as existing in informal agreements among members, as well as in the articles and formal contracts. As a result, section 459 applies not only to situations where there is 'illegality,' such as breaches of constitution, but also to those situations where there is no 'illegality' but a mere breach of an informal agreement in private companies.

Second, the more widely interpreted terminology of 'unfair prejudice' replaces the former restrictive term of 'oppression.' Although it is still unclear what 'unfair prejudice' is, and there is no exact definition of it, case law has laid down some guidelines.[103] (1) Prejudice may include, but is not restricted to a fall, or risk of fall in the value of the petitioner's shares; exclusion from the corporate management may also be a prejudice to the petitioner.[104] (2) Prejudice to the minority must be unfair and not just prejudice *per se*. (3) The test of whether the prejudice was unfair is an objective one.[105] (4) Unlawful conduct does not always amount to unfair prejudice. Trivial misconduct breaching the articles, although unlawful, may not amount to unfair prejudice. The principle that the court should not interfere with corporate management is also recognized in the unfair prejudice remedy. Therefore, the court generally is unwilling to find unfair prejudicial conduct in corporate management; only gross mismanagement can lead to 'unfair prejudice'.[106] Nevertheless, some lawful conduct, if it has contravened the petitioner's legal expectation, may still be regarded as unfair prejudicial conduct.[107] (5) Although the section 459 remedy is not an equitable one and the petitioner need not come with 'clean hands,' the petitioner's conduct can still affect the case; due to the petitioner's conduct the respondent's act may end up not being considered unfair.[108]

102 The reason for this is what Vinelott J. pointed out in *Re Blue Arrow plc* ([1987] B.C.L.C. 585, at 590): '... it must be borne in mind that this is a public company, a listed company, and a large one ... Outside investors were entitled to assume that the whole of the constitution was contained in the articles, read, of course, together with the Companies Act. There is in these circumstances no room for any legitimate expectation founded on some agreement or arrangement made between the directors and kept up their sleeves and not disclosed to those placing the shares with the public through the Unlisted Securities Market.' This approach, together with the unnecessary exit remedy in listed public companies, leads to the few applications of section 459 to listed public companies.

103 For the guidelines see, for example, Law Commission CP 142 (1996), paras. 9.21-9.30.

104 Such as *Re RA Noble* [1983] B.C.L.C., 273; see Law Commission CP 142 (1996), para. 9.30.

105 See, for example, *Re RA Noble*, [1983] B.C.L.C., 273; *Re Saul D Harrison & Sons Plc*, [1995] 1 B.C.L.C. 14.

106 See, for example, *Re Elgindata (No. 1)* [1991] B.C.L.C. 959 at p. 993; also see Boyle (2002), pp. 100-101.

107 *Re Saul D Harrison & Sons Plc*, [1995] 1 B.C.L.C. 14; also see Law Commission CP 142 (1996), paras. 9.21-9.24.

108 *Re RA Noble* [1983] B.C.L.C., 273; also see Law Commission CP 142 (1996), paras. 9.28-9.29.

Third, the CA 1989 added to section 459 the phrase, 'the interests of its members generally'. As a result, the section may provide protection for minority shareholders, not only where the interests of some of the members' are unfairly prejudiced, but also where all members' interests are unfairly prejudiced, for example, where dividends are not paid, or where there are injuries to the company.[109] Since an injury to the company may also give rise to a member's derivative action, this application of section 459 to corporate wrongs may cause an overlap between the section 459 remedy and the derivative action. I will discuss this overlap later in Section 2.2.2.2.

The broadly drafted terms in section 459 make it difficult to define all categories of unfair prejudice cases. Nevertheless, it is generally recognized that breaches of informal agreement among the members and breaches of fiduciary duties by the corporate controllers are two important categories.[110] The Law Commission also recognized that some common allegations under the unfair prejudice remedy are[111]: 'exclusion of a minority shareholder from management'[112], 'misappropriation or diversion of corporate assets'[113], 'failure to provide information'[114], 'improper increases in share capital'[115], and 'excessive remuneration and non payment or payment of inadequate dividends'.[116] Among these the first two allegations are especially frequent.[117]

2.2.2.1.3 Remedies awarded under the unfair prejudice petition

Remedies that may be awarded under the unfair prejudice petition are set out in section 461 of the Companies Act 1985. Section 461(1) gives the court broad discretion 'to make such order as it thinks fit for giving relief in respect of the matters complained of'. Section 461(2) lists several remedies that the court may award to the petitioner 'without prejudice to the generality of subsection (1)'.[118] These remedies include the courts' order to 'regulate the conduct of the company's affairs in the future'[119], the order to 'require the company to refrain from doing or continuing an act complained of by the petitioner or to do an act which the petitioner has complained it has omitted to do'[120], the order to

109 See Law Commission CP 142 (1996), para. 9.31.
110 Davies (2003), p. 521.
111 Law Commission CP 142 (1996), para. 7.2 and part 9.
112 Law Commission CP 142 (1996), para. 9.34.
113 Law Commission CP 142 (1996), para. 9.40.
114 Law Commission CP 142 (1996), para. 9.35.
115 Law Commission CP 142 (1996), paras. 9.36-9.38.
116 Law Commission CP 142 (1996), paras. 9.41-9.43.
117 Law Commission CP 142 (1996), para. 7.2.
118 Section 461(2) of the CA 1985.
119 Section 461(2)(a) of the CA 1985.
120 Section 461(2)(b) of the CA 1985.

'authorize civil proceedings to be brought in the name and on behalf of the company by such person or persons and on such terms as the court may direct'[121], the order to 'provide for the purchase of the shares of any members of the company by other members or by the company itself and, in the case of a purchase by the company itself, the reduction of the company's capital accordingly'[122], and so on.[123] In order to obtain these remedies, the petitioner must state the remedies he seeks. The court normally will not award remedies the petitioner does not specify;[124] sometimes the court will grant remedies which have not originally been sought, but only provided the petitioner agrees.[125]

A detailed discussion of these remedies is not our concern here. However, since unfair prejudicial conduct may be found where the injury was done to the company, the issue arises as to whether the petitioner can be compensated, either directly or indirectly, for those losses that are derived from corporate losses. This issue is actually quite important with regard to the relationship between the unfair prejudice petition and the derivative action. I will discuss this issue in Section 2.2.2.2.3.

2.2.2.1.4 Problems with the unfair prejudice petition

The unfair prejudice petition also has its own problems in practice. First, the proceeding is lengthy and costly.[126] This particular issue has been considered by both the Law Commission and the CLR, and some suggestions for reform have been raised and generally accepted, such as case management and an alternative arbitration scheme.[127] Second, as mentioned in Section 2.2.2.1.1, the petition has hardly ever been applied to public companies. Third, the relationship between the unfair prejudice remedy and the derivative action is still unclear. For example, under what circumstances can the unfair prejudice petition be filed where the

121 Section 461(2)(c) of the CA 1985.

122 Section 461(2)(d) of the CA 1985.

123 For example, the court may award interim orders such as injunction, or even interim payment; see Law Commission CP 142 (1996), para. 10.27, Footnote 71.

124 Law Commission CP 142 (1996), para. 10.1.

125 See Law Commission CP 142 (1996), para 10.1, Footnote 7.

126 See Law Commission CP 142 (1996), para. 11.1.

127 For case management, see Law Commission CP 142 (1996), part 17; Law Commission Report 246 (1997), part 2; for the arbitration scheme, see DTI (01/942), para. 2.27. Neither of these reforms is confined to the unfair prejudice remedy. The Law Commission also recommended some other reforms, but those methods have been rejected either by the Law Commission itself or by the CLR. For example, a new unfair prejudice remedy for smaller companies was recommended but rejected by the Law Commission, see Law Commission CP 142 (1996), part 18; Law Commission Report 246 (1997), part 3. A presumption of unfairness in certain cases of exclusion from management and inclusion of a model exit article in Table A were recommended by the Law Commission but rejected by the CLR, see Law Commission CP 142 (1996), part 19; DTI (00/656), paras 4.103-4.104.

injury was done to the company and, if it is allowed, what remedies may be awarded under it? I will discuss these issues in the following sections.

2.2.2.2 *The relationship between the unfair prejudice remedy and the derivative action*

As mentioned, the unfair prejudice remedy can apply to the situation where the company has suffered losses through misconduct. This application actually blurs the distinction between this remedy and the derivative action. Much of the conduct presently regulated by the section 459 petition might have fallen within the scope of derivative actions before the introduction of this petition.[128] This vagueness also raises the issue of whether the unfair prejudice remedy should completely replace the derivative action, or whether a separate derivative action is still necessary. In fact, the relationship between the unfair prejudice remedy and the derivative action still remains unclear under English law.

2.2.2.2.1 The purpose of the unfair prejudice petition: also providing protection for minority shareholders where the company has suffered losses

When it recommended changes to section 210 of the Company Act 1948, the precursor of section 459 of the Company Act 1985, the Jenkins Committee especially considered the weak position of minority shareholders where misconduct was done to the company and where the wrongdoer, who controlled the company, unduly prevented a corporate action against this misconduct.[129] In such cases, the minority shareholders also suffer indirectly. The Jenkins Committee recognized that such a weak position for minority shareholders could be attributed to the excessive restriction resulting from the exceptions to the *Foss* rule.[130] In order to provide better protection for minority shareholders, the Committee recommended that section 210 of the Company Act 1948 should be changed to give the court discretion as to authorizing a petitioner to bring a proceeding in the name of the company.[131] The Committee's recommendations were later accepted by section 75 of the Companies Act 1980, which subsequently became sections 459(461 of the Companies Act 1985.[132]

The legislature's intention to improve the minority shareholders' position where the company suffered losses became more obvious when section 459 was amended by the Company Act 1989 to extend its application to the situation

128 Law Commission CP 142 (1996), para. 7.2.

129 Jenkins Committee (1962), paras. 206-207. Also see Law Commission CP 142 (1996), para. 7.11.

130 Jenkins Committee (1962), para. 206.

131 Jenkins Committee (1962), para. 206.

132 Law Commission CP 142 (1996), para. 7.12.

where the misconduct is unfairly prejudicial to 'the interests of its members generally'.[133] It is clear from this wording that the section 459 petition applies to those situations where the misconduct was done to the company, and all members' interests were therefore affected equally.

English courts have supported the legislature's approach. In a number of cases the courts have allowed an unfair prejudice petition in the case of breaches of fiduciary duties to the company, even when the facts of these cases could also give rise to derivative actions. The actual availability of a derivative action will not bar a section 459 petition.[134] According to these decided cases, various types of breaches of fiduciary duties may give rise to section 459 petitions, for example, cases involving conflict of interest[135], cases involving the exercise of directors' powers for an improper purpose[136], cases involving not acting *bona fide* in the best interests of the company[137], and cases involving the diversion of corporate funds.[138]

2.2.2.2.2 A derivative action or an unfair prejudice petition: application of the unfair prejudice petition where the company has suffered losses

As mentioned above, a petitioner may bring an unfair prejudice petition where the company has suffered losses and thus circumvent the requirements of the *Foss* rule. However, will a petitioner be free to bring an unfair prejudice petition in any case of corporate losses so that the derivative action is indeed totally replaced? The answer may be no. It is hard to imagine that all the rationales under the derivative action and the *Foss* rule will be dropped.[139] There must be some limitation on the application of the unfair prejudice petition in the case of corporate losses. The Law Commission also clearly insists that a separate derivative action is needed.[140] The question then is how to define the scope of the unfair prejudice petition, or in other words, how to distinguish between the application of the unfair prejudice remedy and the derivative action, where the

133 See Section 2.2.2.1.2.

134 Hoffmann J. is famous for this approach. This can be seen from decisions he has made in several cases, such as *In Re A Company (No. 005287 of 1985)*, [1986] 1 W.L.R. 281; *Re A Company* [1986] B.C.L.C. 382; *Re A Company* [1986] B.C.L.C. 376. Other cases include *Re Saul D Harrison & Sons Plc* [1995] 1 B.C.L.C. 14, *Re Stewarts (Brixton) Ltd.* [1985] B.C.L.C. 4, *Lowe v. Fahey* [1996] 1 B.C.L.C. 262; also see Davies (2003), pp. 513-514.

135 Such as *Re Stewarts (Brixton) Ltd.* [1985] B.C.L.C. 4; *Re London School of Electronics* [1986] Ch. 211; *Re Cumana Ltd.* [1986] B.C.L.C. 430.

136 Such as *Re a Company Ex p. Glossop* [1988] 1 W.L.R. 1068.

137 Such as *Re Saul D. Harrison & Sons Plc.* [1995] 1 B.C.L.C. 14.

138 Such as *Lowe v. Fahey*, [1996] 1 B.C.L.C. 262.

139 Davies (2003), p. 514.

140 Law Commission Report 246 (1997), para. 6.11.

injury was done to the company. The Law Commission has not fully addressed this issue. Nevertheless, we may find some clues in case law.

In *Re Saul D Harrison & Sons Plc*, Hoffmann L.J. declared that 'enabling the court in an appropriate case to outflank the rule in *Foss v. Harbottle* was one of the purposes' of the section 459 petition.[141] However, what is an appropriate case? This complicated issue was addressed by Millett J. in *Re Charnley Davies Ltd. (No. 2)*.[142] In *dicta*, Millett J. held that a separate wrong from the wrong done to the company was not necessary for a successful section 459 petition because in the case of corporate wrong the members' interests might also be unfairly prejudiced. However, in order to satisfy a section 459 petition, it is also not sufficient for the petitioner to allege a mere breach of duties to the company by the controllers. Instead, the petitioner must show something more: he must show that his interests have been unfairly prejudiced by the controller. Millett J. pointed out that 'The very same facts may well found either a derivative action or a s. 459 petition'[143], however, 'This should not disguise the fact that the nature of the complaint and the appropriate relief is different in the two cases'.[144] Just as in the case of the breach of the corporate constitution, there may be more than one legal dimension for the same facts.[145] If mere breach of duties to the company is the complaint and only corporate remedies are sought, the shareholder should bring a derivative action rather than an unfair prejudice petition.[146] The gist of the unfair prejudice petition is the disregard shown toward members' interests rather than the wrong done to the company.[147]

However, the approach in *Re Charnley Davies Ltd. (No. 2)* was not followed by the Scottish Inner House of the Court of Session in the case of *Anderson v. Hogg*.[148] The petition in *Anderson v. Hogg* was against an unlawful payment of a salary and other compensation by the respondent director to himself. The Inner House (Lord Prosser dissenting) ordered the respondent to return the unlawful payment to the company. When considering whether there was unfair prejudice in the case, the Inner House did not follow the approach in *Re Charnley Davies Ltd. (No. 2)*. Lord Coulsfield held that an 'unlawful and materially prejudicial' action itself might be unfair. He held that 'There seems to be no case in which a shareholder's complaint under s. 459 on that basis has been rejected on the ground

141 [1995] 1 B.C.L.C. 14, at p. 18.

142 [1990] B.C.L.C. 760. This case concerns a petition under section 27 of the Insolvency Act, which serves the same role as section 459 of the CA when an administration order is effective.

143 *Re Charnley Davies Ltd. (No. 2)*, [1990] B.C.L.C. 760, at p. 784. Jill Poole and Pauline Roberts also pointed out that 'especially in the context of private companies, it is invariably possible to find some personal wrong deriving from the directors' conduct to bring the action within s. 459 ...' Poole & Roberts (1999), at pp.117-118.

144 *Re Charnley Davies Ltd. (No. 2)*, [1990] B.C.L.C. 760, at p. 784.

145 For a discussion on the breach of the corporate constitution, see Section 2.3.2.

146 See Davies (2003), p. 514.

147 See Hirt (2003a), at p. 104; Davies (2003), p. 514.

148 2002 S.L.T. 354, Inner House.

that, although the action was unlawful and materially prejudicial, it was not unfair'.[149] The case could be decided on the merits in that it involved only two groups of shareholders and so in that case there was little distinction between unlawful misconduct to the company and unfairness to the shareholder.[150] However, if this approach is taken, a wrong done to the company which injures the legal *rights* of the corporation may always be unfairly prejudicial to the shareholder's legal *interests*, therefore, the derivative action might be completely circumvented by the member's applying for a section 459 petition.[151]

2.2.2.2.3 Remedies in the unfair prejudice petition regarding corporate losses

The relationship between the unfair prejudice petition and the derivative action in the case of wrongs done to the company is even vaguer when we turn to the remedies awarded in the petition regarding corporate losses. The reason is that the petitioner may be compensated, either directly or indirectly, for those losses which are derived from the losses of the corporation. For example, there may be a compensatory element in the form of valuation for the purchase order; furthermore, a petitioner may be awarded direct compensation for his reflective losses. In addition, a corporate relief rather than a personal one may be awarded in the petition. In the following sections I will discuss these respectively.

The compensatory element in valuation for the purchase order

A purchase order is the most common remedy that can be awarded under the unfair prejudice petition.[152] The reason for this may be that the unfair prejudice remedy mainly provides protection for members of private companies, especially quasi-partnership companies, where there is normally no exit right for members.[153] Unlike public companies, there is no open shares market for members of private companies, therefore, the exit right provided by the unfair prejudice remedy has been welcomed.[154]

149 2002 S.L.T. 354, Inner House, at p. 360.

150 Davies (2003), p. 515.

151 See Davies (2003), pp. 515-516. However, Hirt pointed out that *Anderson v. Hogg* may not be an important case for English courts since it is a Scottish one and the decision of the case was not based on sufficient authority, see Hirt (2003a), p. 104.

152 Law Commission CP 142 (1996), para. 10.10. This is evidenced by the Law Commission's statistics. According to the Law Commission's statistics, among 156 pieces of unfair prejudice petitions during the period of 1994-1995, 69.9% applied for an order that the petitioner's shares be bought, and 20.5% applied for an order that the respondents sell their shares. See Law Commission CP 142 (1996), Appendix E, Table 1.

153 This could be seen from the fact that unfair prejudice is mostly ascertained in small private companies, see Davies (2003), p. 525.

154 See Law Commission CP 142 (1996), para. 10.10, Footnote 27.

The major difficulty with a purchase order is how to decide a fair value for the shares to be sold.[155] When evaluating the price of the shares, the court should also be subject to the general standard of section 461(1) that 'to make such order as it thinks fit for giving relief in respect of the matters complained of.' Thus, the overriding consideration for the English court concerning valuation is the requirement of 'fairness'.[156] This requirement includes compensating the petitioner for unfairly prejudicial conduct when necessary.[157] Specifically, the court will consider factors such as the basis of the valuation of a minority shareholding (or in other words whether the shares should be valued on a *pro rata* or a discounted basis), the date on which the shares should be valued, adjustments to that valuation, the type of order[158], and so on.[159]

Where the unfairly prejudicial conduct such as misappropriation or mismanagement caused injury to the company, the English court, basing itself on the requirement of 'fairness,' may take the corporate losses into consideration when evaluating the price of the shares to be bought. Put another way, in order to strike a balance of fairness between the parties, the valuation may be carried out on the hypothetical basis that misconduct had not yet occurred and that the company had not yet suffered any loss. For this purpose, the corporate loss may then be hypothetically accounted to the company.[160] As a result, the petitioner shareholder may obtain more than the market value of the shares and his 'indirect loss' (or 'reflective loss') derived from the corporate loss may be compensated in the purchase order.[161] This approach of compensating the petitioner shareholder's 'reflective loss' in the purchase order is different to that under German law, which only evaluates the shares based on their 'market value'.[162]

However, Hirt doubts the appropriateness of redressing the petitioner's reflective loss in awarding the purchase order.[163] He gives several reasons. First, such an order might reduce the value of the company's cause of action against the wrongdoers or affect the position of the creditors, although it also might neither reduce the company's assets (in a case where the order is against the respondent) nor affect the injured company's cause of action against the wrongdoer.[164] Second, such an order also runs contrary to the principle that a shareholder cannot recover damages that are only a reflection of the company's loss.[165]

155 See Law Commission CP 142 (1996), paras. 10.10-10.25.
156 Law Commission CP 142 (1996), para. 10.11.
157 Law Commission CP 142 (1996), para. 10.22.
158 It is also possible for the court to make a purchase order such that the petitioner should buy out the respondent's shares; see Law Commission CP 142 (1996), para. 10.24.
159 Law Commission CP 142 (1996), paras. 10.10-10.25.
160 Law Commission CP 142 (1996), para. 10.21.
161 Law Commission CP 142 (1996), para. 10.22.
162 For a discussion on the German law, please refer to Section 4.2.3.2.1.
163 Hirt (2003a), pp.109-110.
164 Hirt (2003a), p. 106, p. 109; Hirt (2003b), p. 429, Footnote 48.
165 See Hirt (2003a), p. 106, pp. 109-110.

Compensatory damages directly to the petitioner

Although the petitioner's reflective losses, which are derived from the corporate losses, may be compensated in the purchase order, it is open to doubt whether compensatory damages will be awarded to the petitioner directly.[166]

In the Irish case *Irish Press plc. v. Ingersoll Irish Publications Ltd.*[167], the Irish Supreme Court overturned the High Court's order that the respondent should compensate the petitioner directly, on the basis that such a direct compensation was beyond the court's ability under section 205(3) of the Irish Companies Act 1963, which requires that orders should be made '... with a view to bringing to an end the matter complained of ...'.[168] Therefore, Irish law distinguishes between the compensatory element in the valuation of shares in the exit remedy and the court's ability to award compensatory damages in the petitioner's own right.[169] Although section 461 of the UK Companies Act is different from the Irish Act and contains no such limitation as that found under section 205(3) of the Irish Act, the English Law Commission held that 'The approach in the English courts should ... arguably be the same' as the Irish approach.[170]

However, a recent English High Court case has taken the approach that a petitioner may be compensated for his reflective losses in a section 459 petition, and it is at the court's discretion to decide whether to make a purchase order with a complementary element or to award compensatory damages to the petitioner.[171] In *Atlasview v. Brightview*[172], the petitioners claimed that one of the respondents, Mr Shalson, misappropriated the assets of the company (Brightview) for the benefit of the members holding class A shares (the A shareholders) and to the exclusion of the members holding class B shares (the B shareholders). The petitioners brought a section 459 petition, seeking either an order reversing the effect of the undervalued sale and requiring the respondents to account for any profits, or an order that the respondents pay damages to the petitioners.[173] Among other arguments, the respondents raised the 'reflective loss argument,' which stated that the duty they were alleged to have breached was owed to the company rather than the company's shareholders and therefore only the company was the proper claimant. Moreover, any diminution in the value of shares as a result of the breach was merely reflective of the company's losses (if any).[174] However, the High Court of Justice Chancery Division Companies Court rejected the 'reflec-

166 Law Commission CP 142 (1996), para. 10.27.
167 [1995] 2 ILRM 270.
168 For an introduction to the case, see Law Commission CP 142 (1996), para. 10.27, Footnote 72.
169 Law Commission CP 142 (1996), para. 10.22, Footnote 62.
170 Law Commission CP 142 (1996), para.10.27, Footnote 72.
171 *Atlasview v. Brightview*, 2004 WL 741783, para. 63.
172 2004 WL 741783.
173 2004 WL 741783, para. 19.
174 2004 WL 741783, paras. 58-59.

tive loss argument'. It refused to follow the cases relied on by the respondents for the argument such as *Prudential Assurance Company Ltd. v. Newman Industries Ltd. (No. 2)* (the Court of Appeal), *Stein v. Blake (No. 2)*[175] and *Johnson v. Gore Wood & Co.*[176], considering that these cases were 'all concerned with writ actions' and 'do not purport to lay down any principle governing the exercise of the court's power under s.459'.[177] The Court acknowledged that there had been many cases in which a section 459 petition was allowed against a majority shareholder's misappropriation of corporate assets[178], and held that:

> … there is no justification for reading into s.459 a restriction to the effect that a petitioner can only complain if the unfairly prejudicial conduct does not involve a breach by any directors of their duties to the company. Equally, as a matter of interpretation, there is no justification for imposing an absolute bar on the types of relief that the court might award at trial in relation to unfairly prejudicial conduct which happens also to involve a breach by directors of their duties to the company. Indeed, any such interpretation of s.459 would appear to run counter to its express wording, which refers to unfair prejudice 'to the interests of its members generally' or of some part of its members.[179]

The Court also recognized that in such a case a derivative action would have the drawback of unjustly benefiting the wrongdoing majority shareholder:

> … by that route [a derivative action], the defendant transferees would be having to make a payment to the transferor company, the bulk of which they would then recover in their capacity as majority shareholders. That hardly seems like a desirable route for compensating those who have in fact suffered the loss.[180]

As to the form of relief, the Court held that:

> … the 'reflective loss argument' does not provide a bar to any of the relief sought in the Petition. The fact that the impugned conduct might give rise to a cause of action at the suit of the company does not mean that it is incapable also of giving rise to unfair prejudice: nor does it necessarily preclude the court from awarding financial compensation to the petitioners in satisfaction of their claim. In deciding on the appropriate form of relief, the trial judge will no doubt be astute to ensure that the B Shareholders do not achieve double

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175 [1998] 1 B.C.L.C. 573; [1998] 1 All E.R. 724 (CA).
176 [2002] 1 AC 1.
177 2004 WL 741783, para. 59.
178 2004 WL 741783, para. 60.
179 2004 WL 741783, para. 61.
180 2004 WL 741783, para. 62.

recovery by receiving financial compensation directly from the A Shareholders and also retaining their B Shares in Brightview in circumstances where the company is able (if it is) to recover in respect of the same loss: indeed, it seems to me most likely that the trial judge would, if the Petition succeeded, order the Respondents to acquire the Barton Parties' shares, valued on the basis that there had been no transfer to Freshbox, rather than making an award of damages (however described). But that is a matter for his discretion, if and when it comes to considering the appropriate form of relief. It is not a ground for summarily striking out the Petition, or any particular head of relief currently pleaded in it.[181]

Compensation to the injured company

Another vague aspect of the unfair prejudice petition, which is problematic, is whether the court will grant corporate relief in such a petition where the company has suffered losses. Section 461(2)(c) empowers the court to authorize a derivative action to be brought by the petitioner in the name of the company, provided the petitioner succeeds in the unfair prejudice procedure. However, orders by the court to authorize a derivative action could only be found in a very few reported cases.[182] The need to pass two proceedings makes this kind of relief lengthy, costly and inconvenient.[183] It turns out to be unpopular in practice.[184]

Different approaches have been taken with regard to whether English courts should grant compensation to the company under the unfair prejudice petition.[185] The traditional approach was taken in *Re Charnley Davies Ltd. (No 2)*[186], where it was held that corporate relief (that is, a payment to the company) was not appropriate under the section 459 petition. Millett J., as mentioned, held that the essence of the unfair prejudice petition is the disregard of the petitioner's interests rather than the wrong done to the company, although both of them may be found in the same facts. Thus, in such circumstances, whether a derivative action or an unfair prejudice petition is appropriate principally depends on the remedies sought. If only the wrong done to the company is the complaint and corporate remedies are sought, a section 459 petition is not suitable and the aggrieved

181 2004 WL 741783, para. 63.

182 Law Commission CP 142 (1996), para. 10.9.

183 See Poole & Roberts (1999), p. 119; Law Commission CP 142 (1996), para. 10.9.

184 According to the Law Commission's statistics, only 26 out of the 156 petitions between 1994-1995, representing only 16.7%, applied for the 461(2)(c) order. In addition, there are few reported cases where such an order has been awarded. In *Re Cyplon Developments Ltd.* March 3, 1982, (unreported, CA) the order was granted; however, the order was requested but refused in *Re Hailey Group Ltd.* [1993] B.C.L.C. 459; see Law Commission CP 142 (1996), para. 10.9.

185 Law Commission CP 142 (1996), para. 10.27.

186 Also see *Re Little Olympian Each-Ways (No. 3)* [1995] 1 B.C.L.C. 636.

shareholder should bring a derivative action.[187] This approach seems consistent with the *prima facie* understanding that the section 459 petition should provide remedies where there is unfairly prejudicial conduct against the member.

However, in a more recent case the court took a different approach in favoring corporate compensation in section 459 petitions. In *Lowe v. Fahey*[188], Mrs Lowe, a minority shareholder of Fahey Developments Ltd., brought a section 459 petition, alleging that the respondent majority shareholders, Mr and Mrs Fahey, transferred profits of Fahey Developments to a third party, Brickfield Property Ltd., which was under the control of the Faheys. The petitioner sought not only personal relief, that is, an order that either her shares be bought or the respondents' shares be sold out, but also corporate relief, that is, an order that the respondents, the Faheys and Brickfield Property, give an account to Fahey Developments of the funds appropriated. When considering whether corporate compensation could be awarded against both majority shareholders and a third party under the unfair prejudice remedy, the court held that:

> where ... the unfairly prejudicial conduct involves the diversion of company funds, a petitioner is entitled as a matter of jurisdiction to seek an order under s.461 for payment to the company itself not only against members, former members or directors allegedly involved in the unlawful diversion, but also against third parties who have knowingly received or improperly assisted in the wrongful diversion.[189]

However, it is worth noting that although the case appeared to deviate from former cases in the sense that it awarded corporate compensation under the unfair prejudice petition, it might not really have departed from the approach in *Re Charnley Davies Ltd. (No 2)* which held that section 459 should mainly provide protection for members where they are unfairly prejudiced. In *Lowe v. Fahey*, the court also held that 'This is not to say that in a case where the only substantive relief being sought was a claim on behalf of the company against such a third party that a claimant could always proceed by way of petition instead of derivative action'.[190] In other words, only when corporate compensation is one of the remedies sought by the petitioner should the court award corporate compensation, since two separate proceedings would be costly and time wasting. However, if corporate compensation is the only relief sought, the section 459 petition may be inappropriate and a derivative action might be necessary.[191]

The Scottish court went further in *Anderson v. Hogg* (far beyond the approach in *Lowe v. Fahey*. The Inner House of the Court of Session (Lord Prosser

187 See Davies (2003), p. 514.
188 [1996] 1 B.C.L.C. 262. For a comment on the case, see Gray (1997).
189 [1996] 1 B.C.L.C. 262, at p. 268.
190 [1996] 1 B.C.L.C. 262, at p. 268.
191 See Law Commission CP 142 (1996), para. 10.27, Footnote 73.

dissenting) ordered reimbursement of the unlawful payment by the respondent to the company, which was the only relief sought by the petition. As a result, Millett J.'s opinion in *Re Charnley Davies* has been fully rejected.[192]

Researchers take different approaches to the issue as well. Hirt doubts the appropriateness of awarding corporate relief under the section 459 petition because it may not be consistent with the rationales under the *Foss* rule. The question of whether a shareholder should be entitled to enforce the company's rights, the very question which arises in derivative actions, simply cannot be avoided in the section 459 petition.[193] From the opposite perspective, Poole and Roberts argue for flexibility on the section 459 remedies so as to include corporate relief.[194] They raise several reasons for this. First, if the section 459 petition is allowed to address corporate wrongs, it would be ironic and meaningless if corporate remedy was not allowed on the basis that 'the section 459 is not considered an appropriate form of action for such relief'.[195] Second, under the section 459 petition, it would in all practicality be inconvenient if another separate action were needed in order to redress the corporate wrong. Poole and Roberts cited Hoffmann J.'s opinion in *Re A Company (No. 005287 of 1985).*[196] In this case, Hoffmann J., when refusing to strike out this petition whose facts might also give rise to a derivative action, held that:

> Looking at the matter from a practical point of view that [that is, a separate derivative action is needed to redress corporate wrongs in a successful section 459 petition, added by the author] does not seem to me to be very convenient. It would mean separate proceedings having to be commenced by writ and separate pleadings delivered in respect of matters which would very substantially overlap, if not duplicate, the issues canvassed in the petition and affidavits under section 459 ... I would be reluctant to come to the conclusion that this form of duplication was necessary unless it was clear that the jurisdiction under sections 459 and 461 did not permit the whole mater to be dealt with upon the petition.[197]

Third, no extra costs will be incurred if there is no need to begin an independent derivative action. Fourth, if the corporate remedy is awarded under the section 459 petition, other shareholders and creditors may also benefit from it.

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192 See Davies (2003), p. 515.
193 Hirt (2003a), p. 106, pp. 108-109.
194 Poole & Roberts (1999), pp. 119-122.
195 Poole & Roberts (1999), p. 120, Footnote 7.
196 [1986] 1 W.L.R. 281.
197 [1986] 1 W.L.R. 281, at p. 284.

2.2.2.3 *Will the section 459 petition supersede the derivative action under current English law?*

Under current English law, the unfair prejudice remedy might run the risk of completely incorporating the derivative action. This can be seen from the following aspects. First, the application of the unfair prejudice petition is broad enough to cover situations of corporate wrongs, which would have been regulated by the rules of derivative action if the unfair prejudice petition had not been applicable. In order to bring an unfair prejudice petition in the case of corporate wrongs, the petitioner only needs to establish unfairly prejudicial conduct towards his (and other members') legal interests; no specific and separate wrong to the petitioner is necessary.[198] In fact, especially in private companies, it is always possible for the court to identify certain unfairly prejudicial conduct towards the petitioner from the director's breach of duties to the company.[199] In addition, other similarities with regard to the application of the two procedures may contribute to the overlap. For example, both are mainly applied in private companies, both of them may be brought against persons other than majority shareholders and directors, and neither of them applies to mere negligence.

Second, it is normally easier for a member to bring an unfair prejudice petition rather than a derivative action. As we will observe in Section 2.4.1, the substantive and the procedural requirements for the derivative action are very strict. However, if the shareholder brings a section 459 petition, he need not be bothered with these requirements, but only needs to establish that there is unfair prejudicial conduct towards him (and other members). Although the section 459 petitioner cannot obtain indemnity for his litigation costs, he may be able to ask for legal aid that is not available to parties in derivative actions.[200] As a result, it is not surprising to see that shareholders bring the section 459 petition instead of the derivative action in the case of corporate wrongs. The Law Commission also admitted this fact.[201]

Third, the unfair prejudice remedy also provides flexible and fair relief. For example, the petitioner shareholder may be compensated for his reflective losses, which is normally not possible in a shareholder's personal action. Moreover, relief to the injured company may also be awarded under the unfair prejudice petition. This flexible and fair relief, especially when in most cases it is made to the petitioner directly, is of course more attractive to minority shareholders than the corporate relief under the derivative action, which the shareholder can only indirectly benefit from.

However, there may still be room left for the derivative action under English law. Due to the different focuses of the two proceedings, there may be misconduct

198 Poole & Roberts (1999), p. 117.

199 Poole & Roberts (1999), pp. 117-118.

200 Law Commission CP 142 (1996), para. 16.3, Footnote 15.

201 Law Commission CP 142 (1996), para. 16.3.

which amounts to breach of fiduciary duty but not unfair prejudice.[202] This may especially be the case if the derivative action is reformed to encompass breach of director's duty of skill and care, since section 459 only applies to serious mismanagement.[203] In addition, the section 459 petition has its own flaws, such as its lengthy and costly procedure. Therefore, if the aggrieved minority shareholder can easily pass the standing requirements under the derivative action, he may prefer a derivative action to a section 459 petition.[204]

2.2.2.4 Should there be one or two forms of action?

Questions

This broad application of the unfair prejudice petition and its overlap with derivative actions gives rise to the following questions, as raised by Poole and Roberts:

> Should the derivative action be dispensed with in favour of a single form of action, making identification of the type of wrong less significant?
> If the two forms of action remain, should the derivative action be applicable to corporate wrongs and the unfairly prejudicial conduct action reserved for personal wrongs?
> Should it be possible to obtain a corporate remedy by means of a section 459 petition and should it be possible to obtain a personal remedy in a derivative action?[205]

English law

As mentioned, English law regards both the unfair prejudice remedy and the derivative action as being necessary. Moreover, although English courts do not limit the application of the unfair prejudice petition to personal wrongs and may in fact compensate the petitioner's reflective losses or award corporate remedy in the petition, they are relatively conservative towards this broader application. Basically, the unfair prejudice remedy can apply to corporate wrongs where there are also personal wrongs (unfair prejudice to the petitioner) and thus where personal remedies could be sought at the same time.[206]

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202 Boros (1995), p. 233.

203 Law Commission CP 142 (1996), paras 9.44-9.48.

204 Boros (1995), p. 219.

205 Poole & Roberts (1999), p. 112.

206 This can be compared to the Scottish court's approach. In addition, Australian courts take yet another approach: they prefer interpreting the unfair prejudice provision in a way which could supersede the derivative action; see Boros (1995), p. 219.

The Law Commission also supports this case law approach:

> There are still cases where a derivative action is the only or most appropriate route to take. Whilst we noted the tendency of applicants to bring section 459 proceedings in respect of matters which could have given rise to a derivative action, we do not consider that the two should be entirely assimilated. They are different in principle – one gives rise to a personal right which the shareholder can enforce, the other relates to the company's cause of action (and although they may cover some of the same ground, this will not always be the case. As was pointed out on consultation, section 459 has largely become an exit remedy, and what is needed is a remedy for those who want to stay in the company. We consider that a separate and distinct right to bring a derivative action should remain.[207]

As to the remedies granted, the Law Commission seems to insist that the unfair prejudice petition mainly provides personal relief[208], while the derivative action only provides corporate relief.[209]

Researchers' different attitudes toward the English approach

Researchers have taken different stances on the approach taken by English law. One body of opinion doubts the necessity of maintaining a division between the unfair prejudice remedy and the derivative action. The reason given is that the distinction between personal and corporate wrongs is not clear, and, even where it is possible to make a clear distinction, the relationship between the two actions still remains vague.[210] A single form of action is even suggested.[211]

Others argue in favor of this division. However, even here there are disagreements with regard to the wrongs that should be redressed and the remedies that should be awarded under each proceeding. For example, Hirt takes a strict approach. He suggests that in the case of a breach of directors' duties, the role of

207 Law Commission Report 246 (1997), para. 6.11.

208 See Law Commission CP 142 (1996), part 10.

209 The Law Commission suggests that the court should not have the power to grant a personal benefit in a derivative action. The reason is that it is unnecessary and undesirable to do so. On the one hand, the injured shareholder can seek his personal relief via the unfair prejudice remedy that also applies to corporate wrong; on the other hand, personal relief may be in conflict with those policy considerations under the derivative action, such as protection of creditors and other shareholders. See Law Commission CP 142 (1996), para.16.50; Law Commission Report 246 (1997), para. 6.108.

210 See, for example, Poole & Roberts (1999), pp. 115-116; Payne (1998), p. 38.

211 MacIntosh (1991), p. 30. MacIntosh thinks that a single form of action would 'eliminate differences in matters of procedure, costs, standing, and the substantive standard of liability that currently arise as between the derivative and oppression action.'

the section 459 petition should be very limited.[212] He also finds that it is inappropriate to award either personal or corporate relief under the unfair prejudice remedy in order to redress corporate wrongs and that this inappropriateness is caused by 'the overlap between corporate and personal rights and remedies to which a petition under s.459 based on a director's breach of duty give rise'.[213] He points out that 'It is important ... to recognize the conflicting policies that govern and shape different shareholder remedies and to make an informed and consistent policy choice across the range'.[214] Hirt's opinion, however, seems to be different from the more flexible duality approach taken by the English courts and the Law Commission. On the other hand, Boyle suggests that it should be possible to award personal relief as part of the derivative action in appropriate situations, for example, where the compensation to the company may once again be under the control of the wrongdoer. 'There seems no reason why a plaintiff shareholder should be driven to an unfair-prejudice petition if he/she has already chosen to bring a derivative suit'.[215]

Comments

The prevailing approach towards this issue is that a separate derivative action should be maintained, while the application of the unfair prejudice remedy should be flexible. However, we should note that the development of case law shows that the unfair prejudice remedy has been applied in a more flexible way. This might run the risk of the unfair prejudice remedy superseding derivative actions and so this would then lead to only one form of action in practice.

There is another issue regarding the flexible application of the unfair prejudice remedy to which attention should also be paid. As we know, derivative actions are justified in terms of several policy considerations, such as providing protection for the company and the aggrieved minority shareholders, providing protection for creditors and other stakeholders, the principle of majority rule, the principle of no judicial interference in business matters, as well as the avoidance of multiplicity of actions and strike suits. These policy considerations, if we still believe in them, should not simply be avoided through the application of the unfair prejudice petition. Therefore, the court may in fact need to take these policy concerns into account when hearing an unfair prejudice petition.

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212 Hirt (2003a), p. 106, p. 110.
213 Hirt (2003a), p. 106, p. 108.
214 Hirt (2003a), p. 106, p. 110.
215 Boyle (1997), p. 259.

2.3 The proper plaintiff principle: the distinction between shareholders' derivative action and direct action[216]

2.3.1 Introduction

The essence of the distinction between the shareholder's direct action and derivative action is to ascertain the causes behind the action, or in other words, to ascertain whose rights have been infringed or who has been owed duties that have been breached. If a duty is owed to the shareholder and the shareholder's personal rights have been infringed, the infringed shareholder can bring a direct action to recover his direct losses. Otherwise, a corporate action or a derivative action is needed. When the shareholder brings a direct action, normally he cannot claim for those losses that simply reflect the corporate losses.

It is not always easy to distinguish shareholder's personal rights from corporate rights. Traditionally, English law lacks a comprehensive definition of shareholder's personal rights. Nevertheless, for the sake of the distinction, we are able to identify shareholders' personal rights in four instances. First, an individual shareholder has rights derived from other laws such as contract law or tort law. Second, a shareholder has the right conferred on him by corporate legislation. For example, the Companies Act 1985 confers some statutory rights on a shareholder, such as the right to call a shareholders' general meeting[217], the right to receive notice of resolutions to be dealt with in the next AGM[218], the right to challenge resolutions[219], and so forth.[220] Third, the constitution of the company may also grant certain personal rights to a shareholder. Finally, in exceptional situations a fellow shareholder or directors of the company may owe certain duties to an individual shareholder, and if these duties are breached, the shareholder may have a right to claim against this breach. The vagueness of the distinction between shareholder's direct actions and derivative actions lies mainly with these last two groups of rights, which I will discuss in detail in the following sections.

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216 Under English law the shareholder's direct action does not include the unfair prejudice petition, which is not a writ action.

217 The Companies Act 1985, sections 366A(3), 367, 368(1), 371.

218 The Companies Act 1985, section 376.

219 The Companies Act 1985, sections 4, 5, 54.

220 See Law Commission CP 142 (1996), para. 3.2. In Joffe (2000), at pp. 77-102, Joffe classified personal rights under the Companies Act 1985 as rights '(a) to object to an alteration in the company's memorandum of association; (b) to object to a variation of class rights; (c) to object to the giving of financial assistance for purchase of the company's own shares; (d) in connection with company meetings; (e) in connection with the rectification of the register of members; (f) in connection with takeover offers under the CA 1985, Pt XIIIA.' However, it should be noted that not all of these statutory rights are individual rights that can be enforced by a single shareholder.

2.3.2 Claims arising from the breach of a company's constitution

2.3.2.1 Nature of a company's constitution

Under English law a company's constitution is generally regarded as creating a contract between the company and its members and between the members *inter se*.[221] This contractual nature has been established by company law for more than one hundred and fifty years and is now embodied in section 14(1) of the Companies Act 1985[222], which provides that:

> Subject to the provisions of this Act, the memorandum and articles, when registered, bind the company and its members to the same extent as if they respectively had been signed and sealed by each member and contained covenants on the part of each member to observe all the provisions of the memorandum and of the article.[223]

Of course, this contract created by section 14 is not a standard contract but a statutory one. As a result, some contractual principles will not apply to this statutory contract.[224] Moreover, the constitution has another side effect: due to the ensuing registration, statements to outsiders such as investors, directors, and traders are also created.[225]

221 CLR suggested a change from a contractual nature to a statutory one, see DTI (00/1335), para. 5.64. However, all the legal professional bodies have objected to this suggestion, see DTI (00/1335), para. 5.68.

222 DTI (00/1335), para. 5.64; Law Commission Report 246 (1997), para. 7.2.

223 Companies Bill (218) adopts a single constitution and therefore the memorandum of association will not be constitutional any more; see clause 8 of Companies Bill (218). Section 14(1) of the Companies Act 1985 will be replaced by clause 34(1) of Companies Bill (218), which nevertheless does not change the nature or effect of the constitution; see Company Law Reform Bill (190-EN) clause 34, para. 108; clause 34 of Company Law Reform Bill (190) is now clause 34 of Companies Bill (218).

224 Law Commission CP 142 (1996), para. 2.9. In Joffe (2000), at pp. 46-47, Joffe enumerated some differences between the statutory contract and an ordinary one: '(a) variation of an ordinary contract requires consent of all the parties to the contract... The statutory contract is made expressly subject to the provisions of the CA 1985. Amongst other things, these provisions permit the company by special resolution to alter the statement of the company's objects in its memorandum and to alter its article. The statutory contract is therefore subject to variation with the consent of only three-quarters of the members entitled to vote at general meeting. (b) In certain cases, the content of the articles can be overridden by the provisions of the CA 1985 ... (c) Certain alterations to the articles are, however, prohibited by the CA 1985... (d) Terms may be implied into the articles purely on the basis of the construction of their language to give them reasonable business efficacy ... (e) The contract 'is also, unlike an ordinary contract, not defeasible on the grounds of misrepresentation, common law mistake, mistake in equity, undue influence or mistake'. (f) The court has no jurisdiction to rectify articles of association. (g) The statutory contract is not subject to the provisions of the Unfair Contract Terms Act 1977, ss. 2-4.'

225 Davies (2002), p. 243.

2.3.2.2 The twin aspects of the liability arising from a breach of the constitution

The liability arising from a breach of the constitution has twin aspects.[226] It is generally accepted in English law, both in statute and in case law, that the liability arising from *ultra vires* is twofold. Through *ultra vires* conduct, the directors have breached their duties to the company, and the company has breached its section 14 contract with the shareholders at the same time. For example, section 35(2) of the Companies Act provides that 'a member may bring proceedings to restrain the doing of an act which but for subsection (1) would be beyond the company's capacity'. At the same time, subsection (3) of the section provides that 'it remains the duty of directors to observe any limitations on their powers flowing from the company's memorandum'. Such a double-sided liability may also exist where other regulations in the constitution have been breached in addition to breaches due to *ultra vires* conduct. On the one hand, the breach of the constitution may generate actionable shareholder personal rights against the company based on the contractual nature of the constitution. On the other hand, since the directors also have the duty 'to cause the company to conduct its affairs in accordance with its constitution and not to exceed their own authority'[227], the directors will breach their duty to the company if the constitution has been breached. Thus, a breach of the constitution may constitute wrongs both by the company and against the company.

Where the breach of the constitution gives rise to liabilities to both the company and individual shareholders, the identification of the action will depend on the remedies sought by the plaintiff shareholder. This has been clearly illustrated in *Taylor v. National Union of Mineworkers (Derbyshire Area).*[228] In this case, the officers of the union had called an *ultra vires* strike and had already spent some funds on it. The individual member plaintiff both sought an injunction restraining the continuance of the strike and also requested that the officers pay back to the union the funds already spent. The plaintiff succeeded with the former claim, but failed with the latter: the former claim was his personal claim, while the latter one belonged to the company and the plaintiff did not meet the requirements of the *Foss* rule.

2.3.2.3 Vagueness of personal rights conferred by the constitution (the principle of 'mere internal irregularities')

Nevertheless, identification of actions in the case of a breach of the constitution is not as simple as this may appear from the above. One reason is that the English law is rather vague as to the shareholder's personal right to lodge a complaint

226 Davies (2003), pp. 451-452; Davies (1992), pp. 97-99.
227 Davies (1992), p. 96.
228 [1985] B.C.L.C. 237.

concerning the breach of the constitution. Although it is generally accepted that a company's constitution institutes contracts between the company and its members as well as between the members *inter se*, a shareholder of the company does not have a personal right to enforce all articles in the constitution. In fact, there are two restrictions on the shareholder's right to enforce the constitution. The first one is that the constitution only generates 'insider rights': it only confers rights on a shareholder in his capacity as shareholder, not in any 'outsider' capacity such as director or solicitor.[229] The second restriction results from the application of the *Foss* rule principle: 'mere internal irregularities' cannot give rise to shareholders' personal actions (the principle of 'mere internal irregularities'). In *MacDougall v. Gardiner*, Mellish L.J. provided that if the internal affairs of the company were not being properly managed, the company was the proper person to lodge the complaint.[230] In addition, there was no use in having litigation '... the ultimate end of which is only that a meeting has to be called and then ultimately the majority gets its wishes'.[231] In this sense, the *Foss* rule applies to shareholders' direct action as well.

These restrictions have given rise to problems in English law, especially the second restriction.[232] The application of the 'mere internal irregularities' principle has actually generated conflicts under English law. On the one hand, the contractual nature of the constitution provides individual shareholders with the right to claim directly against the breach of the constitution. On the other hand, the 'mere internal irregularities' principle prevents the individual shareholder from interfering with 'mere internal irregularities', even if these 'mere internal irregularities' have breached the constitution.[233] In addition, the scope of the application of the 'mere internal irregularities' principle to shareholder's direct action is rather vague. A shareholder actually may bring a direct action against some 'internal irregularities', such as those in voting procedures, defective notices of meetings, or inadequate notice of certain resolutions.[234] Under English law there is no comprehensive definition of either personal rights or 'internal irregularities', nor is there a definite list of the enforceable personal rights conferred by the constitution: 'It has never been clear of which breaches of the articles the individual shareholder may freely complain'.[235] English case law also shows this ambiguity. There are two irreconcilable lines of judicial authorities

229 Law Commission CP 142 (1996), paras. 2.15-2.20.

230 (1875) 1 Ch. D. 13, at p. 23.

231 (1875) 1 Ch. D. 13, p. 25.

232 Although the first restriction also generates problems, it is generally regarded as justifiable. Therefore, I will not go into any further discussion on this first restriction here. For details on the first restriction, please refer to Law Commission CP 142 (1996), paras. 2.15-2.20 and Davies (2002), p. 244.

233 Davies (2003), p. 451.

234 Law Commission CP 142 (1996), paras. 2.24-2.25; Law Commission Report 246 (1997), para. 7.7.

235 Davies (1992), p. 95.

following the 1870s' cases of *MacDougall v. Gardiner* and *Pender v. Lushington*[236] respectively.[237] In *MacDougall v. Gardiner*, where the chairman of the shareholders' meeting refused a request for a vote and then wrongfully breached the articles, the courts held that the breach was an internal irregularity and that no personal rights were injured. On the other hand, in *Pender v. Lushington*, the facts were similar to those of *MacDougall* and the chairman refused to recognize the votes of nominee shareholders; however, the court held that the breach had injured the shareholders' personal rights.

Different approaches have been taken towards this vagueness. The Law Commission has suggested that there should be no reform of the current law because there was no evidence of hardship having been caused by any difficulty in identifying personal rights conferred by the article.[238] In addition, adding a non-exhaustive list of personal rights enforceable under section 14 would not be useful.[239] The Law Commission also pointed out that in practice the shareholder's personal right to enforce the constitution may be unimportant because of the successfulness of the unfair prejudice remedy.[240] The Law Commission's approach has been adopted by Companies Bill (218), which suggests no changes to the effect of the constitution.[241]

However, Davies finds that the application of the 'mere internal irregularity' principle to the shareholder's direct action against the breach of the constitution is unjustifiable and incoherent.[242] He holds that part of the confusion in English law, as mentioned above, may be caused by the failure to recognize the twin aspects of the liability arising from the breach of the constitution:[243]

> It is wholly unclear why a breach of the articles should be subject to majority control. It is one thing for the majority to forgive a wrong done to the company, quite another for them to purport to forgive a wrong done by the company, which is the essence of a CA1985, s.14 claim ...[244] Even where the shareholder is complaining of a procedural defect in the taking of a decision by the shareholders, it seems correct in principle that the shareholder should be entitled to have the decision taken properly.[245]

236 (1877) 6 Ch.D. 70.

237 Davies (2003), pp. 450-451.

238 Law Commission Report 246 (1997), paras. 7.10-7.12.

239 Law Commission Report 246 (1997), paras. 7.10-7.12.

240 Law Commission Report 246 (1997), para. 7.10.

241 See Company Law Reform Bill (190-EN) clause 34, para. 108. Clause 34 of Company Law Reform Bill (190) has been followed by clause 34 of Companies Bill (218).

242 Davies (2002), pp. 243-245.

243 Davies (2003), p. 451.

244 Davies (2002), p. 244.

245 Davies (2002), p. 245.

As to the two conflicting policies, that between the contractual nature of the constitution and the 'mere internal irregularities' principle, Davies also suggests that today the former policy should take priority over the latter.[246]

The CLR has also taken the approach that the uncertainty caused by the current law should be removed.[247] After considering the unsatisfactory effect of giving a non-exhaustive list of personal rights, since the list will end up being 'arbitrary' and will 'leave in place obscure and inconsistent case in the remaining field'[248], the CLR proposed that 'all obligations imposed by the constitution should be enforceable by individual shareholders unless the contrary is provided in the constitution'.[249] However, the court would have the power to dismiss an action in a 'trivial' or 'fruitless' situation.[250] Moreover, the shareholder would only 'be entitled to damages for loss suffered in his personal capacity, as opposed to derivative loss suffered as a result of damage to the company'.[251]

2.3.3 Claims arising from the director's breach of fiduciary duties

2.3.3.1 The general principle

Under English law the general principle is that directors owe duties, both fiduciary duties of loyalty and good faith and duties of care and skill, to the company since they are regarded as agents of the company (shareholders collectively) instead of agents of individual shareholders.[252] Generally no duties are owed by directors to individual shareholders.[253] This principle was first established in *Percival v. Wright*[254] and has been followed ever since. In *Stein v. Blake (No. 2)*, the Court of Appeal held that in the case of the director's misappropriation of company assets, the directors' duties were owed to the company; no duties to shareholders existed even when the value of shares had diminished. As a result, in the case of breach of directors' duties, shareholders normally can only bring a derivative action rather than a direct action.

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246 Davies (2003), p. 451.
247 DTI (00/1335), para. 5.64.
248 DTI (00/1335), paras. 5.72-5.73.
249 DTI (00/1335), paras. 5.73, 5.65; DTI (01/942), para. 7.34.
250 DTI (00/1335), para. 5.66; DTI (01/942), para. 7.34.
251 DTI (00/1335), para. 5.73.
252 Davies (2002), p. 116. These duties also apply to any officer of the company who is authorized to act as an agent of the company, especially to those acting in a senior managerial capacity; Davies (2003), p. 379.
253 See such as Davies (2003), p. 374.
254 [1902] Ch. 421.

2.3.3.2 *Exceptions to the general principle*

However, the decision in *Percival v. Wright* has been criticized over the years.[255] It is argued that there should be some exceptions to the general principle; in other words, directors may owe fiduciary duties to individual shareholders in certain situations in order to protect individual shareholders' interests. Where a director has breached his duties to individual shareholders, those injured shareholders may bring a direct action against him.

The problem of the exceptions to the general principle is how to define these exceptions. That is, how to define the scope of the circumstances where a director owes duties to individual shareholders directly. If the scope of such duties is too broad, the *Foss* rule and the policies under the *Foss* rule will be seriously injured since shareholders will be able to circumvent the *Foss* rule simply by bringing a direct action.[256] If, on the other hand, the scope of such duties is too narrow, the individual shareholder's interests may not be well protected. English law has traditionally favored the *Foss* rule and recognized the director's duties towards individual shareholders only in very exceptional cases, which I will discuss in the following sections.[257]

In the case of established legal relationships

It is generally accepted that directors owe duties to individual shareholders directly where there are established legal relationships between them. For example, where the directors are authorized to give advice to the shareholders concerning the exercise of their rights or to negotiate on their behalf, such as in selling shares to a potential takeover bidder, here the directors are to be regarded as the agents of the individual shareholders instead of agents of the company.[258] Therefore, it is a natural conclusion that these directors owe fiduciary duties to these individual shareholders which are independent of those directors' fiduciary duties owed to the company. These then are the prime situations where directors do, in fact, owe duties to individual shareholders.

In the case of special factual relationships

A more controversial issue is whether directors should owe duties to individual shareholders where there is only a 'special factual relationship' between them, as opposed to an established legal relationship. Such duties were first fully accepted by the New Zealand Court of Appeal in *Coleman v. Myers*.[259] The case involved

255 Davies (2003), p. 374; Arsalidou (2002), p. 62.
256 Davies (2003), p. 452.
257 Davies (2003), p. 452.
258 A famous case is *Allen v. Hyatt* (1914) 30 T.L.R. 444, P.C. See Joffe (2000), p. 67.
259 [1977] 2 NZLR 225.

a small family company with unlisted shares. The shareholders of the company had traditionally relied on the directors for information and advice. Disputes arose where the directors recommended to the shareholders a takeover bid by a company that was wholly owned by the directors. In the recommendation, the directors did not disclose the material fact that the value of the target company would be increased as a result. Although in this case the directors were not agents of the shareholders, the court held that the directors still owed fiduciary duties to the shareholders directly because of certain special factors in this case. The court accepted that the directors' fiduciary duty to individual shareholders does not always exist, nor is it possible to establish any general standard as to when the fiduciary duty will arise. Nevertheless, there are some factors which may help to decide whether there are such duties, such as the family-based character of the company, the directors' dominant position in both companies, the directors' high degree of insider knowledge, the existence of a reliance relationship, and the shareholders' dependence upon information and advice.

The approach in *Coleman v. Myers* has recently been accepted by English case law as well. In *Platt v. Platt*[260], where the special factual relationship between the director and the shareholders was similar to that in *Coleman v. Myers*, David Mackie Q.C. held that the defendant director owed a fiduciary duty to the shareholder plaintiffs, following the reasoning in *Coleman v. Myers*. In *Peskin v. Anderson*[261], the English Court of Appeal also accepted the distinction between the directors' duties to the company and those to individual shareholders and recognized that the directors may owe duties directly to the individual shareholders in the case of a special factual relationship between them. However, after analyzing the facts of this case, the court concluded that in the current case there was no such special relationship which might give rise to the directors' duties to shareholders: in this case, the company was not a family company, the alleged breach was the directors' conduct of the company's affairs, the directors had no conflicts of interest in the sale of shares, and there was no suggestion that the plaintiff shareholders asked for the directors' advice. Since *Peskin v. Anderson*, the special fact exception has been generally accepted in English law.[262] Although there is no general standard determining what amounts to 'a special factual relationship', it is clear that only a few situations can satisfy the standard. Those possible situations may include those involving family or small companies, or, if in companies with large numbers of shareholders, where directors give their advice during a takeover bid.[263]

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260 [1999] 2 B.C.L.C. 745, Ch. D., partly reversed on another basis by *Platt v. Platt* [2001] 1 B.C.L.C. 698, CA, 2000 WL 1918531.

261 [2001] B.C.C. 874, [2001] 1 B.C.L.C. 372, 2000 WL 1841707.

262 Davies (2002), p. 232.

263 For example, see *Re A Company* [1986] B.C.L.C. 382; see Davies (2003), p. 376.

In the case of directors' exercising powers for improper purposes

It is problematic whether an individual shareholder can bring a direct action against the directors where they have exercised their powers for improper purposes. It is generally accepted in English law that directors bear the duty not to exercise the powers conferred on them by the constitution for an 'improper' or 'collateral' purpose.[264] However, what is unclear is who can enforce the claims against the directors if they have breached this duty. In the dictum of *Re A Company (No. 5136 of 1986)*, which was an unfair prejudice petition[265], Hoffman J. held that although the directors' breach of duty in acting with an improper purpose when allotting shares was

> ... in theory a breach of its duty to the company, the wrong to the company is not the substance of the complaint ... The true basis of the action is an alleged infringement of the petitioner's individual rights as a shareholder ... An abuse of these powers is an infringement of a member's contractual rights under the articles.[266]

Although Hoffmann J. did not directly recognize that the directors owed duties to individual shareholders in this case, he did, however, anticipate that this kind of improper-purpose act by directors could be regulated by the shareholders' exercise of their statutory contractual rights.[267] A bolder approach was taken by the Supreme Court of South Australia in *Residues Treatment and Trading Co. Ltd. v. Southern Resources Ltd. (No. 4)*.[268] In this case the directors had also issued new shares for an improper purpose in a takeover bid, and the court held that the plaintiff shareholder had a personal, equitable right against the directors' misbehavior.[269]

Nevertheless, Hoffman's approach is not consistent with other English cases. For example, in *Bamford v. Bamford*[270], the Court of Appeal held that the directors' abuse of power by allotting shares not *bona fide* in the interests of the company was not a breach of the articles and therefore not a wrong done to the individual shareholders but to the company.

In the case of directors' breach of duty to act fairly as between shareholders

Another controversy concerns the directors' duty to act fairly as between shareholders. In *Mutual Life Insurance Co. of New York v. The Rank Organization*

264 Davies (1992), p. 99.
265 [1987] B.C.L.C. 82.
266 [1987] B.C.L.C. 82, at p. 84.
267 Joffe (2000), p. 70.
268 (1988) 14 ACLR 569; see Sealy (2001), at p. 484.
269 For a brief introduction to the case, see Sealy (2001), at p. 484; Davies (1992), at p. 101.
270 [1969] 1 All E.R. 969.

Ltd.[271], the court held that it was an implied term in the articles of association that directors had the duty to act fairly as between shareholders, which was enforceable by individual shareholders. The Law Commission also accepted that 'A director must act fairly as between different members'[272], however, it did not clarify whether such a duty could be enforced by individual shareholders.[273] The CLR's attitude has been clearer but conservative. The CLR finds that the directors' basic duty to 'promote the success of the company for the benefit of the members as a whole'[274] includes the duty to 'achieve outcomes that are fair as between its members'.[275] Therefore, according to the CLR's opinion, although the directors bear the duty to act fairly as between shareholders, such a duty is not separately owed to individual shareholders and thus cannot be enforced by individual shareholders.[276] The CLR's approach has been accepted in Companies Bill (218).[277]

2.3.4 Claims arising from the majority shareholders' misconduct

The majority shareholders may abuse their controlling power either through the board of directors or through the general meeting of shareholders. In the former case, under English law the majority shareholders may be regarded as '*de facto*' or 'shadow' directors and therefore be subject to the directors' liability rules.

Where the majority shareholders exercise their voting rights in the general meeting, the traditional English view is that shareholders have no general fiduciary duties either to the company or to other shareholders. Differing from the fiduciary nature of directors' powers, the shareholders' voting rights are based on their possession of shares and thus are proprietary rights.[278] When exercising their voting rights, the shareholders may do so for their own interests, even if the interests are opposed to those of the company. Actually the traditional English law does not exclude the interested shareholders from voting.[279] In *Re Astec (BSR) plc.*, Jonathan Parker J. held that

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271 [1985] B.C.L.C. 11.

272 Law Commission and the Scottish Law Commission (1999), Appendix A 'Draft Statement of Directors' Duties,' para. 10, p.184.

273 Davies (2002), p. 233, Footnote 61.

274 DTI (01/942), p. 345 (Annex C, Schedule 2, para. 2(a)).

275 DTI (01/942), p. 345 (Annex C, Schedule 2, para. 2, Footnote (2) (b)), and p. 352 (Annex C, Explanatory Note 18).

276 Davies (2002), p. 235.

277 Clause 173 of Companies Bill (218).

278 See, for example, Davies (2003), p. 438; Davies (2002), p. 220; Hirt (2004b), pp. 98-99; Payne (1999), p. 611; Hollington (1999), pp. 8-11.

279 See, for example, *North-West Transportation Co Ltd. v. Beatty*, (1887) 12 App. Cas. 589, PC.

> … in general the right of a shareholder to vote his shares is a right of property which the shareholder is free to exercise in what he regards as his own best interest. He is not obliged to cast his vote in what others may regard as the best interests of the general body of shareholders, or in the best interests of the company as an entity in its own right.[280]

However, giving the majority shareholders complete freedom to exercise their voting rights without constraint may cause the majority shareholders to abuse their voting power and thus to infringe upon the interests of the company and minority shareholders. English case law has also been aware of this risk and has put restrictions on the majority shareholders' voting rights in certain situations. For example, in *Allen v. Gold Reefs of West Africa Ltd.*[281], the court laid down a standard that a decision to alter the company's articles should be made 'bona fide for the benefit of the company'. If the shareholders have breached this standard when making a decision to alter the company's articles, the individual dissenting shareholders will be granted the power to have the decision reviewed.[282] However, the application of this standard in English case law is not clear; for example, it is not clear, according to this standard, how far the majority shareholders should consider the interests of the company.[283] In fact, the courts have vacillated between the conflicting principles of non-interference within business matters and the protection of minority shareholders.[284]

We should also bear in mind that the statutory mechanism of the unfair prejudice remedy actually plays an important role in restricting the majority shareholders' abuse of power. In addition, clause 239 of the Companies Bill (218) suggests that an interested shareholder should be excluded from voting for ratification of a director's misconduct. This new restriction will definitely prevent the majority shareholders' abuse of voting power in ratification of misconduct.

2.4 Striking a balance between corporate efficiency and protection for the company and the minority shareholders

2.4.1 Rules in the common law derivative action

The English law on derivative actions is well known for favoring the efficiency of corporate management rather than providing protection for minority shareholders. This approach can be examined from the following aspects.

280 [1998] 2 B.C.L.C. 556, 584c-d.
281 [1900] 1 Ch. 656, at p. 671.
282 Davies (2002), pp. 234-235.
283 Davies (2003), pp. 486-496.
284 Davies (2003), p. 487.

2.4.1.1 Substantive limitations on the scope of derivative actions

2.4.1.1.1 Whose misconduct may lead to a derivative action

Persons who may infringe upon a company's interests can be classified into three types: directors, intra-corporate persons other than directors such as majority shareholders, or a third party. It is generally agreed that derivative actions should not be allowed to seek relief for the company in respect of a cause of action arising from a third party's misconduct, because the power to make a corporate litigation decision lies within the board of directors. It is also generally agreed that where the directors themselves injured the corporate interests, a derivative action should be allowed, provided other requirements have been satisfied, because the directors cannot make a fair litigation decision for the company due to conflict of interest. However, it is problematic whether a derivative action should be allowed against misconduct by the majority shareholders. Two different approaches can be taken towards the issue: the first one is that where the cause of action arises from the misconduct of majority shareholders, derivative actions may be allowed as well; the second approach, however, does not allow a derivative action.

Compared to the first approach, the second approach tends to favor more the director's power to make corporate litigation decisions and therefore puts more limitations on the minority shareholders' right to derivative actions. The rationale under the second approach is, where there is no breach of duty by a director, the company itself via the board of directors should have the freedom to make litigation decisions.[285] This approach has both advantages and disadvantages. On the one hand, it protects the board's business judgment and prevents minority shareholders from abusing the right to derivative actions. On the other hand, it has the disadvantage of providing insufficient protection for the company and minority shareholders. For example, where the principle misconduct is committed by the majority shareholders, the board of directors may make a negative litigation decision against them, not because the negative litigation decision is in the best interest of the company, but because the majority shareholders have exerted influence on the board or because the board is unwilling to sue these shareholders to whom they are closely related. In order to redress the remedy, a minority shareholder can only sue the board for its breach of duty by making such a negative litigation decision. It is not an easy job, however, especially considering the court's traditional unwillingness to hold directors liable for the breach of duty of care and skill.

Current English law takes the first approach, which is that a derivative action can be brought against wrongdoers such as majority shareholders, officers and

285 Law Commission CP 142 (1996), para. 16.8.

employees as well as directors, provided the plaintiff shareholder has satisfied the requirements for a derivative action. Nevertheless, the difference between the two approaches actually has been reduced under English law due to the requirement of 'wrongdoer control' for bringing a derivative action and the law of shadow directors.[286] In fact, the defendants in derivative actions are normally directors with many shares. Contrary to the current approach, the Companies Bill takes the second approach: a derivative claim can only be brought in respect of a cause of action arising from the misconduct of directors.[287] I will discuss this in Section 2.4.2.2.1.

2.4.1.1.2 Nature of the defendant's misconduct that may lead to a derivative action

All Western jurisdictions accept that directors should be allowed a certain amount of discretion in business judgments.[288] Therefore, minority shareholders may not initiate derivative actions against the director's reasonable business decisions even if those decisions cause damage to the company. However, it is difficult to demarcate a clear boundary between misconduct which may lead to a derivative action, and misconduct which may not. There are two approaches to this issue. One is that the law sets up a boundary between these two kinds of misconduct *ex ante*, or in other words, the law provides in advance that only certain kinds of defendant misconduct may give rise to derivative actions.[289] The other approach is that while in principle all kinds of defendant misconduct may give rise to derivative actions, the court will follow the principle of not interfering with the directors' business judgment when hearing cases.[290]

The current English common law takes the first approach. According to the *Foss* rule, a minority shareholder cannot sue against misconduct if it is a mere *irregularity* which is *ratifiable* by a simple majority of shareholders. This in fact limits the scope of the derivative action: a minority shareholder may only bring a

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286 Under English company law, a shadow director, in accordance with whose directions or instructions the directors of the company are accustomed to act, will be treated as a director in regard to the duties and liabilities; see section 741 of the Company Act 1985. Also see clause 251 of Companies Bill (218).

287 Clause 260(3) of Companies Bill (218).

288 Timmerman (2004), p. 50.

289 The English common law derivative action is an example of this approach. Other examples include the abolished section 147 (3) of the German AktG (1998) and the current section 148 of the German AktG (as reformed by the UMAG); see Section 4.4. The American style of business judgment rule plays a similar role to the *ex ante* restriction: according to the business judgment rule, the plaintiff needs to prove certain misconduct of directors in order to rebut the presumption that the defendant director is deemed to have fulfiled his duty; therefore, the plaintiff needs to prove something more than the director's mere breach of duty in order to hold the director liable; see Section 3.4.1.2.

290 This approach is suggested by Companies Bill (218); see Section 2.4.2.2.2.

derivative action against non-ratifiable misconduct. However, this English approach of an *ex ante* limitation has its own defects. It may not provide sufficient protection for the company and minority shareholders, since English law identifies a broad scope of ratifiable misconduct, which may not give rise to derivative actions. As mentioned in Section 2.1.2.2, under English law only illegal or *ultra vires* conduct, an act in breach of a special majority or procedural requirement (the special majority situation), or a fraudulent act are non-ratifiable, whereas ratifiable wrongs cover a wide range of misconduct, including non-disclosure of a conflict of interest, negligence through which the wrongdoers did not benefit personally at the expense of the company, the exercise of power for a collateral purpose, and so on.[291] No derivative action may be brought against these ratifiable wrongs even though they may cause losses to the company. Another defect of the English restriction is that it is difficult to make a clear distinction between ratifiable and non-ratifiable misconduct.

As we will observe, the Companies Bill abandons the English common law approach and adopts the second mechanism: it extends the application of derivative actions to all directors' breaches of duties.[292] I will discuss the Companies Bill's approach in Section 2.4.2.2.2.

2.4.1.2 Procedural requirements on plaintiffs for bringing derivative actions

2.4.1.2.1 The requirement of being a current member of the company

Under English law only a current member of the company can bring a derivative action.[293] A former member has no such right even if he was a member when the wrong was done to the company. The rationale is that if the current members are not willing to bring a derivative action, a former member has no reason to do so.[294] On the other hand, a current member can do so even if he joined the company after the wrong. Therefore, there is no contemporaneous ownership requirement as there is in American law because 'the right to bring proceedings as a member in respect of the wrong is part of the bundle of rights represented by a share and can be transferred to a transferee'.[295] It is said, however, that the fact that the claimant was not a member when the alleged wrong took place would be taken into consideration by the court when granting permission to allow a derivative action.[296]

291 Hannigan (2000), p. 504.
292 Clause 260(3) of Companies Bill (218).
293 Law Commission CP 142 (1996), paras. 20.32-20.34.
294 Law Commission Report 246 (1997), para. 6.50.
295 Law Commission Report 246 (1997), para. 6.98.
296 Hollington (1999), p. 29.

For our purposes a member is defined under section 22 of Companies Act 1985 as:[297]

> (1) The subscribers of a company's memorandum are deemed to have agreed to become members of the company, and on registration shall be entered as such in its register of members. (2) Every other person who agrees to become a member of a company, and whose name is entered in its register of members, is a member of the company.[298]

As a result, no beneficial shareholder will be allowed to bring a derivative action. The Companies Bill continues to adhere to this approach.[299]

2.4.1.2.2 The three standing requirements under modern case law

As mentioned in Section 2.1.3.1, the *Foss* rule assumes the role of providing *locus standi* requirements as well as substantive requirements for derivative actions. Therefore, in order to bring a derivative action, a plaintiff shareholder needs to satisfy three standing requirements which actually make it very difficult to initiate a derivative action under English law. First, he must *prima facie* prove that the misconduct against the company central to his complaint is non-ratifiable.[300] Second, he must *prima facie* prove that there is no wrongdoer control. This requirement applies to all derivative action cases.[301] And, third, no independent body of the company has made a decision not to sue in the name of the company. The first two requirements were already discussed in Section 2.1; the law on the third requirement is still in a state of development[302], and I will discuss this third requirement further in Section 2.4.1.3.

2.4.1.2.3 Rule 19.9 of the CPR: the court's approval etc.

As mentioned in Section 2.1.4, rule 19.9 of the Civil Procedure Rules (as amended in 2000) specifically deals with the procedures to bring a derivative action. According to this rule, there are several basic steps in bringing a derivative action. First, one or more aggrieved shareholders must make a claim that the

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297 Law Commission Report 246 (1997), para. 6.50.

298 This will be replaced by clause 112 of Companies Bill (218), which nevertheless only adds some words 'to make it clear that the subscribers to the memorandum become members on registration of the company, even if the company fails to enter their names in the register of members'; see Company Law Reform Bill (190-EN) clause 111, para. 234; clause 111 of Company Law Reform Bill (190) is now clause 112 of Companies Bill (218).

299 Clause 260(1) & (4) of Companies Bill (218).

300 *Prudential Assurance Co. Ltd. v. Newman Industries Ltd. (No. 2)* (the Court of Appeal), [1982] Ch. 204; see Section 2.1.2.

301 *Taylor v. National Union of Mineworkers (Derbyshire Area)* [1985] B.C.L.C. 237; *Smith v. Croft (No. 2)*, [1988] Ch. 114; see Section 2.1.3.

302 *Smith v. Croft (No. 2)*, [1988] Ch. 114; see Section 2.1.3.3.

company is entitled to a remedy[303], and in that claim the company must be a defendant.[304] Second, after the claim form has been issued the plaintiff must apply for permission of the court to continue the claim[305]; this application must be supported by written evidence.[306] Third, the claim form, application notice and written evidence must be served on the defendant within a certain period, in any event, at least fourteen days before the court is to deal with the application.[307] Finally, if permission to continue the claim is given by the court, the defendant must file a defense within fourteen days after the date on which the permission is given or such period as the court may specify.[308]

The most important feature in this rule is that the plaintiff is required to seek leave of the court to continue a derivative action; otherwise, he may not be allowed to take any further steps in the proceeding. This approach to judicial control of derivative actions is well stated by Launcelot Henderson Q.C., as a deputy judge of the High Court, in *Portfolios of Distinction Ltd. v. Laird and others*:

> Far from being a technicality, the provisions of the rule reflect the real and important principles that the Court of Appeal reaffirmed in Barrett v. Duckett, and underline the need for the court to retain control over all the stages of a derivative action.[309]

Several principles regarding the requirement that the court should decide as a preliminary issue whether to grant leave and how the court should make this decision were stated in *Barrett v. Duckett*[310] and repeated in *Portfolios of Distinction Ltd. v. Laird and others*:

> 4. When a challenge is made to the right claimed by a shareholder to bring a derivative action on behalf of the company, it is the duty of the court to decide as a preliminary issue the question whether or not the plaintiff should be allowed to sue in that capacity.
> 5. In taking that decision it is not enough for the court to say that there is no plain and obvious case for striking out; it is for the shareholder to establish to the satisfaction of the court that he should be allowed to sue on behalf of the company.
> 6. The shareholder will be allowed to sue on behalf of the company if he is bringing the action *bona fide* for the benefit of the company for wrongs to the

303 CPR, rule 19.9(1).
304 CPR, rule 19.9(2).
305 CPR, rule 19.9(3).
306 CPR, rule 19.9(4).
307 CPR, rule 19.9(5).
308 CPR, rule 19.9(6).
309 [2004] EWHC 2071, 2004 WL 1640261, at para. 60. For a detailed discussion of the case and the reasons for the judicial control, see Reisberg (2005a).
310 [1995] 1 B.C.L.C. 243, at p. 250.

> company for which no other remedy is available. Conversely if the action is brought for an ulterior purpose or if another adequate remedy is available, the court will not allow the derivative action to proceed.[311]

Although *Barrett v. Duckett* was decided before the introduction of rule 19.9, Launcelot Henderson Q.C. held in *Portfolios of Distinction Ltd. v. Laird and others* that the principles should 'remain valid today and should inform the exercise by the court of its discretion whether or not to permit a claimant to continue a derivative claim'.[312]

However, since rule 19.9 itself does not clarify those factors which the court should take into account when making a preliminary decision to grant leave, theoretically the court might have great discretion in handling a derivative action. If the court is flexible enough to relax the strict case law requirements, it may, as Boyle points out, 'have removed many of the past artificial barriers to derivative litigation'.[313] Reed even thinks this rule makes it too easy for a plaintiff to bring a derivative action.[314] He finds that due to the relatively early stage that the court will grant leave and to the lack of sufficient evidence (only written evidence supplied by the plaintiff) the court is more likely to give permission; as a result, the company and the defendant are to some extent deprived of the essential protection under the *Foss* rule.[315] However, will the English court be radical enough to make such a reform and then abandon the standing requirements in case law? The answer may be negative. It is more likely that when considering whether to grant leave to continue a derivative action, the court may still be concerned with the standing requirements under case law.[316] *Portfolios of Distinction Ltd. v. Laird and others* is a good example.

2.4.1.2.4 Other situations which may bar a derivative action

Inequitable conduct on the part of the plaintiff shareholder

Since a derivative action is a remedy afforded by equity to protect the interests of the company and the minority shareholders, the court will take into account equity principles when deciding whether to allow a derivative action.[317] As a result, the plaintiff must come with 'clean hands', as any inequitable conduct, such as receipt of proceeds with knowledge of the illegality, acquiescence or

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311 [2004] EWHC 2071, 2004 WL 1640261, at para. 57.

312 [2004] EWHC 2071, 2004 WL 1640261, at para. 58.

313 Boyle (2002), p. 33.

314 Reed (2000).

315 Reed (2000), pp. 156, 159.

316 See Mayson et al. (1996), p. 545; Poole & Roberts (1999), p. 103; Davies (2003), p. 457, Footnote 79.

317 See Law Commission CP 142 (1996), para. 5.18; Hollington (1999), p. 29; Joffe (2000), pp. 22-24.

laches, may bar a derivative action. This was well elucidated in *Nurcombe v. Nurcombe*:

> In my judgment, that case [*Towers v. African Tug Co.,* [1904] 1 Ch. 558, added by the author] establishes that behaviour by the minority shareholder which, in the eyes of equity, would render it unjust to allow a claim brought by the company at his instance to succeed, provides a defense to a minority shareholder's action. In practice, this means that equitable defenses which would have been open to defendants in an action brought by the minority shareholder personally (if the cause of action had been vested in him personally) would also provide a defense to those defendants in a minority shareholder's action brought by him.[318]

Ulterior purpose and the availability of other adequate remedies

Equity also requires the court to consider all the circumstances when deciding whether to grant a derivative action, including the plaintiff's purpose in bringing the action and the availability of other remedies.[319] In *Barrett v. Duckett*[320], the derivative action was struck down because the plaintiff brought the action for personal reasons rather than in the company's interest and because liquidation was 'an alternative remedy such as to make the derivative action inappropriate'.[321]

The fact that the company is in liquidation

The fact that the company is in liquidation will also prevent a derivative action.[322] Where a company is in liquidation, the liquidator will take control of the company's affairs away from the board and the shareholders. Thus, it is the liquidator instead of the board or the shareholders' meeting, with the permission of the liquidation committee or the court if necessary, who will have the power to begin an action in the name of the company.[323] There is no opportunity for the wrongdoing directors or shareholders to repress such an action, and therefore it is not necessary to allow a derivative action.

A shareholder may ask the liquidator to bring an action against the wrongdoer.[324] If the liquidator refuses, the shareholder may obtain an order from the court asking the liquidator to bring such an action according to sections

318 [1985] 1 W.L.R. 370, p. 378.
319 Hollington (1999), p. 29.
320 [1995] 1 B.C.L.C. 243, at p. 250. For a detailed discussion of the case, please see Sealy (1995).
321 [1995] 1 B.C.L.C. 243, at p. 255.
322 See, for example, *Fargro v. Godfrey* [1986] 1 W.L.R. 1134.
323 Hollington (1999), p. 28; Joffe (2000), p. 26; Law Commission CP 142 (1996), para. 5.20.
324 Joffe (2000), p. 26.

112(1) or 168(5) of the Insolvency Act 1986, or may obtain an order permitting the shareholder to bring the action in the name of the company.[325]

2.4.1.3 The appropriate independent body's view: Smith v. Croft (No. 2)

As mentioned in Section 2.1.3.3, *Smith v. Croft (No. 2)* acknowledged that where an independent body of the company decided not to bring a suit against the misconduct in the name of the company, this negative litigation decision would bar a shareholder's derivative action. The rationale is that a company's independent body is regarded as being more appropriate than is an individual shareholder to make a litigation decision in the best interest of the company.[326] This case shows the English approach of favoring the collective nature of corporate decisions.

However, it is not clear under English law which is the appropriate independent body: the independent directors, or the independent shareholders, or both? In *Smith v. Croft (No. 2)*, Knox J. suggested a very flexible solution: he was of the opinion that the appropriate independent body 'will vary according to the constitution of the company concerned and the identity of the defendants who will in most cases be disqualified from participating by voting in expressing the corporate will'.[327] Actually it appears that an appropriate independent body can be a group of shareholders, the directors or a committee of the directors.[328] Currently there is no criterion on the size of the independent body, thus it could be a very small group.[329] Nevertheless, the weight attached to the independent body's opinion may vary according to its size.[330] It is also possible that in many cases such an independent body may not exist at all.[331]

There are also problems with the practical application of the appropriate independent body. The first one is how to judge its independence. In *Smith v. Croft (No. 2)*[332], Knox J. generally agreed with the test applied by the Court of Appeal in *Allen v. Gold Reefs of West Africa Ltd.*[333], that is, whether the votes were 'exercised *bona fide* for the benefit of the company as a whole'. Knox J. also referred to a more detailed standard:

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325 *Fargro v. Godfrey* [1986] 1 W.L.R. 1134. See Joffe (2000), p. 26; Law Commission CP 142 (1996), para. 5.20.

326 Davies (1992), p. 89; Hirt (2004b), p. 168.

327 [1988] Ch. 114, at p. 185.

328 Law Commission CP 142 (1996), para. 4.29.

329 See Law Commission CP 142 (1996), para. 4.29; Poole & Roberts (1999), p. 110.

330 Poole & Roberts (1999), p. 110.

331 Law Commission CP 142 (1996), para. 4.18.

332 [1988] Ch. 114, at p. 186. See Law Commission CP 142 (1996), para. 4.28.

333 [1900] 1 Ch. 656, at p. 671.

> … votes should be disregarded if, but only if, the court is satisfied either that the vote or its equivalent is actually cast with a view to supporting the defendants rather than securing benefit to the company, or that the situation of the person whose vote is considered is such that there is a substantial risk of that happening. The court should not substitute its own opinion but can, and in my view should, assess whether the decision making process is vitiated by being or being likely to be directed to an improper purpose.[334]

The second issue concerns the effect of the independent body's opinion. In other words, if an appropriate independent body makes a decision not to sue, whether that decision should be binding. In *Smith v. Croft (No. 2)*, Knox J. regarded the decision as decisive.[335] Hollington also pointed out that the court would hardly allow a derivative action ignoring the independent body's negative litigation decision.[336]

Third, it is still not clear who bears the burden of proving the independent body's point of view.[337] Davies holds that although *Smith v. Croft (No. 2)* did not require the plaintiff shareholder to prove that the independent body had also made a decision to sue the defendant, it seems clear that, according to Knox J., if the defendant can show that the plaintiff shareholder did not have the support of the appropriate independent body, the action against the defendant should not be allowed.[338] This may significantly deter a derivative action.

Although *Smith v. Croft (No. 2)* did not explicitly refer to American law, the approach of the independent body's opinion is said to be influenced by the American law which allows for a special litigation committee in derivative actions.[339] However, this approach concerning the opinion of the independent body has attracted much criticism in England.[340] Unlike in the United States where the attitude toward the derivative action is normally less hostile[341], the English law of derivative actions had already been criticized for being inappropriately unfavorable to the injured company and minority shareholders, even before *Smith v. Croft (No. 2)*, and it is widely acknowledged that this extra restriction on bringing a derivative action found in *Smith v. Croft (No. 2)* will make a derivative action 'extremely difficult to bring except in the smallest companies'.[342]

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334 [1988] Ch. 114, at p. 186.

335 See Hollington (1999), p. 28.

336 Hollington (1999), p. 28.

337 Hirt (2004b), p. 176; Davies (2003), p. 462, Footnote 8.

338 Davies (1992), p. 89.

339 See Boyle (1990), p. 3.

340 See such as Boyle (1990); Ho (1998), pp. 650-652.

341 As to American law, please see Chapter 3.

342 See Boyle (2002), p. 29. This view is shared by other lawyers such as in Davies (2002), p. 226, where it is said 'after this decision [*Smith v. Croft (No 2)*, added by the author], it is arguable that there is no longer a right for individual shareholders to take the litigation decision'.

2.4.1.4 Incentives for individual shareholders to pursue derivative actions

2.4.1.4.1 Costs and indemnity: providing negative incentive

The general principle of costs allocation under English law is that 'the costs follow the event'[343]; in other words, the losing party pays the winning party's costs as well as his own costs.[344] However, this general principle may be unreasonable for derivative actions: due to the derivative and representative nature of the derivative action, the recovery will be channeled to the company, and the plaintiff shareholder in a derivative action will not directly benefit from the action. If the plaintiff shareholder has to bear the costs while at the same time not being able to benefit directly, he may not be willing to initiate a derivative action. Therefore, an exception to this general principle, which applies to derivative actions, was introduced in *Wallersteiner v. Moir (No. 2)*.[345] In this case the Court of Appeal held that the plaintiff shareholder in a derivative action might have the right to be indemnified by the company for costs.[346] This exception was formalized later in RSC, O 15, r 12 A (13), which is now substituted by CPR, part 19, rule 19.9(7). According to this rule, the court has the discretion to order the company to indemnify the plaintiff shareholder against any liability with respect to costs incurred in the action even if the action fails, provided he has acted reasonably and in good faith in bringing the action. An application for a costs indemnity order can be made, together with an application for leave to continue the derivative action.[347]

However, the indemnity rule may only alleviate the plaintiff shareholder's burden of costs to a certain extent, rather than totally removing that burden. An indemnity granted by the court usually does not cover all the costs the plaintiff shareholder has incurred, even if he is impecunious.[348] In fact, the court's power to decide the amount of the indemnity is regarded as a way the court exercises its supervision of the derivative action: it provides financial impetus to ensure diligent action by the plaintiff and to avoid meaningless or strike suits.[349]

2.4.1.4.2 The conditional fee agreement

The English law on indemnity only reduces the plaintiff shareholder's negative incentive to initiate derivative actions. Additionally, individual shareholders may

343 CPR 44.3 (2) (a).
344 Lowry (1997), p. 253, Footnote 69.
345 [1975] QB 373.
346 [1975] QB 373, pp. 400-401, per Buckley L.J.
347 Boyle (2002), pp. 36-37.
348 See Law Commission CP 142 (1996), para. 6.14 and Footnote 41.
349 Law Commission CP 142 (1996), para 6.14 and Footnote 41; also see Davies (2003), p. 455.

still require positive incentives in order to initiate derivative actions, due to the continuing shareholder's under-incentive problem. This under-incentive problem may be more obvious in England because, as mentioned in Section 2.4.1.2.4, English law on derivative actions does not allow the plaintiff shareholder to bring a derivative action for ulterior motives.

Nowadays the well-known mechanism for generating shareholders' positive incentive, or perhaps more precisely, the shareholders' lawyers' positive incentive, is the contingency fee arrangement.[350] Nevertheless, although the contingency fee arrangement is widely applied and regarded as a strong incentive for encouraging derivative actions in the United States[351], traditionally in England it has been considered to be contrary to public policy.[352] Although English law has recently developed the conditional fee agreement, which is regarded as a step toward the American contingency fee arrangement[353], it is still uncertain whether the conditional fee agreement applies to derivative actions. According to a conditional fee agreement, if the client wins, the lawyer will be able to charge the normal fee and an additional fee which is no more than one hundred percent of the normal fee[354]; if the client loses the case, he need not pay the lawyer's fee[355], but he may still need to pay other costs, such as the winner's fee.[356] This conditional fee agreement was first introduced into English law by section 58 of the Courts and Legal Services Act 1990[357] in limited situations, but currently it may apply to any type of court litigation except criminal proceedings and family proceedings.[358] However, there is doubt as to whether the conditional fee agreement is applicable to derivative actions.[359] The reason for this is that, as Boyle pointed out, in derivative actions the benefits of a successful action must be awarded to the nominal defendant company instead of to the plaintiff shareholder, therefore the agreement may not permit the plaintiff shareholder's 'bargaining away' any

350 For an introduction to the contingency fee arrangement, please refer to Section 3.4.4.2.

351 See, for example, Hirt (2004b), pp. 132-133; also see Section 3.4.4.2.

352 Hirt (2004b), p. 133.

353 Hirt (2004b), p. 133.

354 Article 4 of the Conditional Fees Agreements Order1998 (SI 1998 No.1860), which is substituted by article 4 of the Conditional Fee Agreements Order 2000 (SI 2000 No. 823).

355 See Andrews (1998); Boyle (2002), p. 37, p. 83.

356 Hirt (2004b), p. 133, Footnote 60.

357 1990c.41. Section 58 of the Courts and Legal Services Act 1990 was substituted by section 27(1) of the Access to Justice Act 1999 (c.22).

358 Section 58A(1) of the Courts and Legal Services Act 1990 (as amended by section 27(1) of the Access to Justice Act 1999 (c.22)) and article 3 of the Conditional Fee Agreements Order 2000 (SI 2000 No. 823).

359 In *Wallersteiner v. Moir (No. 2)* [1975] QB 373, the different approaches to the conditional fee agreement already existed. Lord Denning, in principle, agreed with the agreement to be employed in derivative actions; however, taking a different approach, the majority of the Court of Appeal held that the court had neither the power nor good reason to sanction such an agreement.

part of the benefits which do not belong to him.[360] English courts also show hesitancy in applying the conditional fee agreement to derivative actions: there seems to have been no such cases up until now.[361]

2.4.1.4.3 Conclusion

To sum up briefly, the incentive problems generated by the current English law are mainly under-incentive problems rather than over-incentive ones. On the one hand, due to the principle of cost arrangement and the court's control of reimbursement, the individual shareholder may still bear the costs or a part of them; this discourages the individual shareholder from initiating derivative actions. On the other hand, the conditional fee agreement, which may generate positive incentive for the individual shareholder, has still not been applied to derivative actions in practice.

2.4.1.5 Limiting directors' financial exposure to the risks and costs of litigation

Under English law a director can only eliminate or reduce his possible liability for damages and his burden of costs for litigation in derivative actions by asking the company to buy director and officer insurance on his behalf. He cannot be indemnified by the company for his liability arising from cases where the judgment comes down against him.[362] This lack of protection for directors from financial risk may result from the lenient approach of English law towards holding directors liable, except in situations of serious mismanagement.

2.4.2 Changes in the Companies Bill

2.4.2.1 Introduction

The purpose of the new statutory derivative action

As mentioned in Section 2.1.5, the Companies Bill suggests substituting a new statutory derivative action for the common law derivative action. The purpose of the new statutory derivative action would be to introduce a 'new derivative procedure with more modern, flexible and accessible criteria for determining whether a shareholder can pursue an action'.[363] Nevertheless, it is not purported

360 Boyle (2002), p. 37, p. 83.
361 Hirt (2004b), p. 134.
362 Hearnden & Mendelssohn (2005), at p. 62.
363 Law Commission Report 246 (1997), para. 6.15; Company Law Reform Bill (190-EN), Part 11, Chapter 1 (Derivative Claims and Proceedings by Members), para. 468; Part 11, Chapter 1 of Company Law Reform Bill (190) is now Part 11, Chapter 1 of Bill 218.

to 'formulate a substantive rule to replace the rule in *Foss v. Harbottle*'.[364] In fact, the reform would not affect the current balance of power between shareholders and managers under English law or the underlying policy that a derivative action may be brought only in limited circumstances.[365] As a result, and as admitted by the Law Commission, the new statutory derivative action would not 'make significant changes to the availability of the action' and would not represent 'a large overall increase in litigation'.[366]

Problems with the common law derivative action as identified by the Law Commission

In its Consultation Paper the Law Commission perceived four major problems with current common law derivative action.[367] First, the rule is obscure and outdated. It could only be found in case law, much of which was decided many years ago. Moreover, it is difficult to reconcile all these decided cases.[368] Second, the plaintiff can only bring a derivative action if he can prove wrongdoer's control. This causes problems especially in listed public companies where the shareholding is scattered and therefore difficult to prove wrongdoer control.[369] In addition, under the current law the meaning of wrongdoer control is unclear and restrictive. Third, a minority shareholder cannot bring a derivative action against the breach of director's duty of care and skill unless he can prove that the negligence has benefited the wrongdoer or that the failure of the other directors to bring an action constitutes a fraud on the minority.[370] Fourth, the fact that the standing for a minority shareholder to bring a derivative action has to be determined as a preliminary issue results in the action being lengthy and costly.[371] As will be seen in the following sections, the reforms of common law derivative actions have mainly focused on the problems just mentioned.

2.4.2.2 *The new law concerning substantive limitations on the scope of derivative actions*

As mentioned in Section 2.4.1.1, a common law derivative action may arise from the breach of duty by the majority shareholders as well as by the directors.

364 Company Law Reform Bill (190-EN), Part 11, Chapter 1, para. 468. Part 11, Chapter 1 of Company Law Reform Bill (190) is now Part 11, Chapter 1 of Bill 218.

365 Diana Faber, the Law Commissioner, said that, 'Our aim is to provide speedy, fair and cost effective mechanisms for resolving disputes between minority shareholders and those running companies, without disturbing the current balance of power between members and managers,' see Law Commission CP 142 (1996), executive summary. Also see Law Commission Report 246 (1997), executive summary.

366 Law Commission Report 246 (1997), para. 6.13.

367 Law Commission CP 142 (1996), paras. 14.1-14.4.

368 Law Commission CP 142 (1996), para. 14.2.

369 Law Commission CP 142 (1996), para. 14.2.

370 Law Commission CP 142 (1996), para. 14.3.

However, the nature of the misconduct that may give rise to derivative actions is restricted: the plaintiff shareholder can only bring a derivative action against non-ratifiable misconduct. Nevertheless, the Companies Bill changes both aspects of these substantive limitations. The result, therefore, may well be that the availability of the derivative action might be slightly narrower as far as the causes of actions are concerned, while remaining slightly broader regarding the scope of the liability.[372]

2.4.2.2.1 Whose misconduct may lead to a derivative action

According to the Companies Bill, the availability of derivative actions should be limited to claims arising from breaches or proposed breaches of directors' duties, including claims against third parties as a result of such breaches, for example, according to the rules of constructive trusts or tracing.[373] For this purpose, 'directors' will include a former director, and a 'shadow' director will be treated as a director.[374] This is also the approach suggested by the Law Commission.[375] The reason for this limitation, as elucidated by the Law Commission, is that where the director did not breach his duties, the company itself should have the freedom to decide whether to bring an action against the corporate wrong.[376] Consequently, there may be two kinds of derivative actions against directors for their breaches of duties. The first type comprises cases against directors who breached their duties and caused injuries to the company by themselves.[377] The second type of case is that against those directors who did not injure the company by themselves but breached their duty by not pursuing an action against the wrongdoer. In this second type of case, it is the third party (including majority shareholders, officers and employees of the company) rather than the director who caused direct injury to the company.[378] Nevertheless, a derivative action can only be brought against the directors rather than against the wrongdoing third party because the cause of action against the wrongdoing third party 'does not arise out of the breach of duty' by directors.[379] However, it is doubtful whether this second type of derivative action will be allowed by the court, since making a

371 For example, in *Smith v. Croft (No. 2)* [1988] Ch. 114, the preliminary stage took 18 days; see Law Commission CP 142 (1996), paras. 6.6, 14.4.

372 Law Commission Report 246 (1997), paras. 6.13, 6.24-6.37, 6.38-6.41.

373 Companies Bill (218) clause 260(3), which was Company Law Reform Bill (190) clause 243(3), also see Company Law Reform Bill (190-EN), clause 243(3), para. 471.

374 Companies Bill (218) clause 260(5).

375 Law Commission CP 142 (1996), para. 16.8; Law Commission Report 246 (1997), para. 6.24.

376 Law Commission CP 142 (1996), para. 16.8.

377 What misconduct or what breach of duty may give rise to derivative action is an issue I will discuss in the next section.

378 Law Commission Report 246 (1997), paras. 6.31-6.35.

379 Law Commission Report 246 (1997), paras. 6.27, 6.31-6.35.

litigation decision is a business judgment which the court is normally unwilling to interfere with.

This new approach under the Companies Bill may make the availability of derivative action narrower than that found under the current common law derivative action, especially regarding claims against the wrongdoing majority shareholders.[380] There is no difference where the wrongdoer is a normal third party because it is virtually impossible to pursue a derivative action against a normal third party under the common law derivative action; there have been no such cases either.[381] However, where the wrong was committed by a majority shareholder rather than a director, a derivative action may be allowed under common law but not allowed under the Companies Bill. The Law Commission has illustrated the reasoning behind the approach found in the Companies Bill. As viewed by the Law Commission, in such cases the main conflict is regarded as being between the majority shareholder and the minority shareholder, and that therefore the appropriate remedy for the aggrieved minority shareholder is personal action under the articles of association or, more likely, the unfair prejudice remedy.[382] If the aggrieved minority shareholder also wants redress in the form of a corporate remedy, he may bring the unfair prejudice petition and apply for an action to be brought in the name and on behalf of the company.[383] Although this means that a section 459 petition is necessary, the Law Commission held that 'it seems to us preferable to leave the court to do this than, at least in the first instance, to open the door to derivative litigation against third parties by having a wider rule'.[384]

The Companies Bill's restriction of derivative actions to the directors' breach of duties actually shows the traditional English approach of being unfavorable to derivative actions. It may also lead to less protection for the interests of the company and other stakeholders where the majority shareholder has committed wrongs against the company. First, if the aggrieved minority shareholder only seeks personal relief in such cases, the company's injury may not be redressed. And, second, seeking an action in the name and on behalf of the company via the section 459 petition is too troublesome to be a practical solution. Although theoretically the board should bring a corporate action to redress the corporate damage, it is doubtful whether it would do so against the majority shareholder of the company.

380 Law Commission Report 246 (1997), paras. 6.13, 6.24-6.37.
381 Law Commission Report 246 (1997), para. 6.33.
382 Law Commission Report 246 (1997), para. 6.30.
383 Law Commission Report 246 (1997), para. 6.29.
384 Law Commission Report 246 (1997), para. 6.29.

2.4.2.2.2 The nature of the defendant's misconduct that may give rise to a derivative action

The Companies Bill also adopts the Law Commission's recommendation that a derivative action may be brought with respect to an alleged breach of any duty of directors, including the duty to exercise reasonable care, skill and diligence.[385] It is not necessary for the plaintiff to prove that the misconduct is non-ratifiable, nor to show that the wrongdoing directors control the company.[386] This extension is intended to address the deficiency in the current law that there may be no remedy against the director's negligence in most cases: under common law a derivative action against the director's negligence may only be pursed if the alleged wrongdoer also has profited through this negligence. Moreover, a section 459 petition can only be sought to redress the director's serious mismanagement.[387] In this sense, the scope of the new derivative action should be broader than the common law derivative action.[388] This is reasonable considering the Companies Bill's restriction on the causes of derivative action.

The extension of the derivative action to directors' negligence certainly will increase the risk of unjust interference with corporate management. However, the Law Commission finds that there is no need to worry about this risk since the new derivative action will be under tight judicial control.[389] It is a deeply rooted principle in English case law that the court should not unjustly interfere with the corporate manager's business decisions. The Law Commission also declines to introduce a statutory business judgment rule[390] and gives some reasons for this: first, it is a long-established judicial approach that English courts do not 'second guess' directors on commercial matters nor take the advantage of hindsight[391]; second, there is no other reason to codify the rule[392]; third, a statutory business judgment principle, although it may lead to greater certainty, might not be as broad or flexible as the common law one.[393] This approach has also been adopted by the Companies Bill.

385 Companies Bill (218) clause 260(3), which was Company Law Reform Bill (190) clause 243(3), also see Company Law Reform Bill (190-EN), clause 243(3), para. 471.

386 Company Law Reform Bill (190-EN), Part 11, Chapter 1, para. 468. Part 11, Chapter 1 of Company Law Reform Bill (190) is now Part 11, Chapter 1 of Bill 218.

387 Law Commission Report 246 (1997), para. 6.38.

388 Boyle doubts the practical effect of the extension: since negligence may be ratified, obtaining the court's leave may be not as easy as in the case of fraud; in addition, the standard of directors' duty of skill and care might be raised; see Boyle (2002), p. 67.

389 Law Commission Report 246 (1997), para. 6.41. For the rules of the judicial control, see Section 2.4.2.3.

390 Law Commission and the Scottish Law Commission (1999), paras. 5.21-5.29.

391 Law Commission and the Scottish Law Commission (1999), para. 5.28.

392 Law Commission and the Scottish Law Commission (1999), para. 5.29.

393 Law Commission and the Scottish Law Commission (1999), para. 5.28.

2.4.2.3 *The new law of the procedural requirement on plaintiffs to initiate derivative actions*

2.4.2.3.1 The requirement of the court's permission to continue a derivative action: a preliminary trial

The most important procedural requirement for initiating a derivative action under the Companies Bill is that a member of the company who initiates a derivative action must apply to the court for permission to continue the action.[394] This requirement reflects the current procedure under the Civil Procedure Rules. According to the Companies Bill, it is no longer necessary for the plaintiff to satisfy the standing requirements established by the *Foss* rule, that is, those requirements to prove that the misconduct is non-ratifiable, that there is no wrongdoer control, and that there is no negative litigation decision by the independent body. In fact, by means of the requirement of a preliminary trial, the Companies Bill grants the court greater power to control the derivative action.

2.4.2.3.2 A two-stage procedure for the preliminary trial

Unlike the recommendations of the Law Commission and the CLR, the Companies Bill introduces a two-stage procedure in the preliminary trial for granting permission to continue a derivative action.[395] At the first stage, the plaintiff shall establish a *prima facie* case for giving permission; if he cannot do so, the court must 'dismiss the application and may make any consequential order it considers appropriate'.[396] At this stage, the court will only make its decision based on the evidence submitted by the plaintiff; evidence from the defendant will not be required.[397] If the plaintiff survives the first stage, he then proceeds to the second one. At the second stage, the court may require evidence to be provided by the company and will decide whether to grant permission.[398] The Companies Bill lists those circumstances where the court must refuse permission and those factors the court must consider when deciding whether to give permission.[399]

394 Companies Bill (218) clause 261. The same requirement applies if the plaintiff wants to continue the claim as a derivative claim; see Companies Bill (218) clause 262.

395 Companies Bill (218) clause 261, which was Company Law Reform Bill (190) clause 244, also see Company Law Reform Bill (190-EN), Part 11, Chapter 1, para. 469. Part 11, Chapter 1 of Company Law Reform Bill (190) is now Part 11, Chapter 1 of Companies Bill (218).

396 Companies Bill (218) clause 261(2).

397 Companies Bill (218) clause 261(2), which was Company Law Reform Bill (190) clause 244(2), also see Company Law Reform Bill (190-EN), Part 11, Chapter 1, para. 469. Part 11, Chapter 1 of Company Law Reform Bill (190) is now Part 11, Chapter 1 of Companies Bill (218).

398 Companies Bill (218) clause 261(3) & (4), which was Company Law Reform Bill (190) clause 244(3) & (4), also see Company Law Reform Bill (190-EN), Part 11, Chapter 1, para. 469. Part 11, Chapter 1 of Company Law Reform Bill (190) is now Part 11, Chapter 1 of Companies Bill (218).

399 Companies Bill (218) clause 263(2), (3) & (4).

Although this two-stage procedure enables the courts to dismiss unmeritorious cases at the very beginning of the action without disturbing the defendants or the company, and has the advantage of efficient trials[400], it may make the shareholder's access to derivative actions more difficult. Another problem with the Companies Bill is that it is silent on what amounts to a *prima facie* case for giving permission. Actually, this two-stage procedure takes a step back from the Law Commission and the CLR's recommendations.

2.4.2.3.3 The matters which the court should consider in deciding whether to grant permissio

Clause 263 of the Companies Bill (Bill 218) stipulates that:

> (2) Permission (or leave) must be refused if the court is satisfied—
> (a) that a person acting in accordance with section 173 (duty to promote the success of the company) would not seek to continue the claim, or
> (b) where the cause of action arises from an act or omission that is yet to occur, that the act or omission has been authorised by the company, or
> (c) where the cause of action arises from an act or omission that has already occurred, that the act or omission—
> (i) was authorised by the company before it occurred, or
> (ii) has been ratified by the company since it occurred.
>
> (3) In considering whether to give permission (or leave) the court must take into
> account, in particular—
> (a) whether the member is acting in good faith in seeking to continue the claim;
> (b) the importance that a person acting in accordance with section 173
> (duty to promote the success of the company) would attach to continuing it;
> (c) where the cause of action results from an act or omission that is yet to occur, whether the act or omission could be, and in the circumstances would be likely to be—
> (i) authorised by the company before it occurs, or
> (ii) ratified by the company after it occurs;
> (d) where the cause of action arises from an act or omission that has already occurred, whether the act or omission could be, and in the circumstances would be likely to be, ratified by the company;
> (e) whether the company has decided not to pursue the claim;
> (f) whether the act or omission in respect of which the claim is brought gives rise to a cause of action that the member could pursue in his own right rather than on behalf of the company.

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400 Company Law Reform Bill (190-EN), clause 244, para. 472. Clause 244 of Company Law Reform Bill (190) is followed by clause 261 of Companies Bill (218).

(4) In considering whether to give permission (or leave) the court shall have particular regard to any evidence before it as to the views of members of the company who have no personal interest, direct or indirect, in the matter.

Several comments may be made concerning the above regulation. First, the Companies Bill distinguishes those circumstances in which the court must refuse permission from those circumstances that the court must take into account but that are not decisive. Where a person acting in accordance with section 173 would not seek to continue the claim, or where the conduct or omission giving rise to the cause of action has been authorized or ratified by the company, the court must refuse permission. In the former case, the action will not be in the best interests of the company, while in the latter case, there is simply no cause of action due to the authorization or ratification.[401] We should pay attention here to the fact that the Companies Bill makes an important change to the traditional English law on ratification: according to clause 239 of the Bill, the decision of a company to ratify a director's conduct, which amounts to negligence, default, breach of duty or breach of trust in relation to the company, must be made by the members, and the votes in favor of the ratification by the director (if he is also a member of the company) or any connected member shall be excluded. Unlike the traditional law which states that a member can vote for his own interests and cannot be excluded from voting, this change definitely provides more protection for the company and minority shareholders.

Second, the Companies Bill makes a non-exhaustive list of matters which the court should take into account in deciding whether to give permission. These matters are important for the court's decision but are not decisive, although some of them, such as whether the misconduct is ratifiable or not, may bar a derivative action under common law. This list also shows that the Companies Bill takes the traditional non-favorable approach towards the shareholder's right to derivative actions.

Third, the Companies Bill regards the viewpoint of the independent members as being especially important in the court's decision but not decisive in it either. This helps to clarify the vagueness of common law with regard to the independent body's view.

2.4.2.4 Comments on the Companies Bill's regulation

There is no doubt that the Companies Bill will improve the minority shareholder's right to derivative actions. The new statutory derivative action applies to an alleged breach of any duty by directors, and it is not necessary for the plaintiff to prove wrongdoer control, which may improve the minority shareholder's right to derivative actions in public companies as well. Furthermore, an independent body's negative litigation decision will not bar a derivative action, and moreover,

401 Law Commission Report 246 (1997), paras. 6.84-6.86.

the new law is also more accessible and predictable.[402] However, we also acknowledge that this Bill still maintains the traditional attitude of not favoring derivative actions and will not affect the current balance between corporate efficiency and the protection of minority shareholders. This can be seen in at least two examples: the derivative action is restricted to the breach of duty by directors, and a two-stage procedure is required in the preliminary trial necessary for granting permission to continue a derivative action.

Another feature of the new statutory derivative action is that the court is granted greater discretion in controlling derivative actions. Actually, under the new scheme judicial oversight, rather than the obstacle of substantive and procedural requirements, is the major method for keeping a balance between corporate efficiency and the protection of minority shareholders.

2.5 Conclusion

2.5.1 The function of derivative action in English corporate governance

2.5.1.1 An unimportant role for derivative action

The derivative action only plays a minor role in English corporate governance. The major reason for this unimportant role is the English attitude towards derivative actions and the balance between corporate efficiency and the protection of minority shareholders. The difficulty a shareholder has in bringing a derivative action under common law actually reflects this attitude. Although the Companies Bill suggests introducing a new statutory derivative action which will make a derivative action more accessible, it is not expected to significantly improve the role of derivative actions since the basic attitude has not changed.

Another reason for the unimportant role of derivative actions is that there exists an alternative remedy which is more attractive. In England, minority shareholders have three main remedies: the derivative action, the unfair prejudice remedy, and the shareholder's personal right to enforce articles of association. Among them the unfair prejudice remedy is, for all practical purposes, the most important. This flexible remedy supplements the derivative action to a great extent since it may apply to those circumstances where the injury was done to the company and where the petitioner can be compensated for his reflective loss in such cases.

We should bear in mind, however, both the unfair prejudice remedy and the derivative action provide protection mainly to minority shareholders in privative companies. There are obstacles to applying either of them to minority shareholders in public companies. English strategies for disciplining corporate

402 However, it is also argued that such a list is not helpful in guiding advisors or shareholders; see, for example, Reisberg (2006), pp. 100-101.

managers and protecting the interests of the company and minority shareholders in public companies, especially publicly listed companies, are mainly market related, for example, the shareholders' removal rights over the directors and their exit rights coupled with the takeover offer.[403]

2.5.1.2 *Neglecting the function of public purpose for derivative action*

As we know, the derivative action has a function of public purpose, especially in public companies.[404] However, the public purpose seems to be neglected by English law. For example, English law has paid more attention to personal relief rather than corporate relief. English practice shows that the derivative action, under which remedies are awarded to the company, is not regarded as an important mechanism. The major remedy sought by minority shareholders, even if in the case of corporate wrongs, is the unfair prejudice remedy, which provides personal relief (mostly an exit remedy). The Companies Bill also states that the possibility for the aggrieved party to pursue an action in his own right should be a factor to be considered by the court in deciding whether to grant permission to continue a derivative action.[405] This attitude of favoring personal relief may, however, result in the problematic situation where the interests of the injured company itself may not be protected.

The unimportant role given to minority shareholders in improving corporate governance is also shown by the main relief they normally receive: whether in private or public companies, exit is normally the most common relief. It seems that minority shareholders have less chance of a 'voice' in companies, or they are not encouraged to give their 'voice'. As a result, they may play a less important role in improving corporate governance.

2.5.2 *The English model of striking a balance between corporate efficiency and protection of the interests of the company and of minority shareholders*

2.5.2.1 *The appropriate body for making a litigation decision in the best interests of the company*

English law has been endeavoring to identify the appropriate body to make a litigation decision in the best interests of the company. Generally this power is granted to the board of directors. Where the board is unwilling to sue, according to English common law it appears open to the shareholders collectively (normally in general meetings) to bring an action.[406] Moreover, traditionally an individual

403 Davies (2002), p. 253.

404 Bottomley (1992).

405 Companies Bill (218), clause 263(3)(f).

406 See Davies (2003), p. 445.

shareholder can also bring a derivative action in exceptional situations. Recently, English law has also identified two other bodies which are regarded as being more appropriate than an individual shareholder for making a litigation decision for the company: according to *Smith v. Croft (No.2)*, the decision of a company's independent body not to sue should prevent an individual shareholder from initiating a derivative action.[407] In addition, rule 19.9 of the Civil Procedure Rules requires that an individual shareholder's right to derivative actions should be subject to the court's permission.

Two features may be identified regarding English law. First, as to enforcing corporate claims, English law has been striving to preserve the collective nature of corporate decisions. Therefore, the roles of the general meeting, the independent body, and the individual shareholder in making a litigation decision for the company decrease respectively. Although English law is still in a state of development, especially since the law on the independent body has still not been settled, it continues to consider the derivative action as a last resort. As long as there is another intra-corporate body that can make a fair litigation decision, it can bar a derivative action. Therefore, under current English law, it is extremely difficult for an individual shareholder to initiate a derivative action. The second feature is that the court, as an outsider, is granted the power to decide whether to permit a derivative action.

The Companies Bill, despite certain amendments, maintains these features. First, the court is still regarded as being the appropriate body to decide whether a derivative action should be permitted. The Companies Bill actually grants the court even more discretion in making such a decision; although the intra-corporate body's litigation decisions are important in the court's decision, they are no longer decisive. The court can exercise its own discretion in deciding whether the action should be continued. As a result, unlike traditional common law, which tries to identify the appropriate body within the company to make a corporate litigation decision, the Companies Bill chooses an external body, the court. Second, the Companies Bill also tries to preserve the collective nature of corporate decisions. This can be seen from those matters which the court should take into account when deciding whether to grant permission: the court should consider, among other matters, whether the company has decided not to pursue the claim and, in particular, any evidence before it regarding the views of independent members of the company.[408]

407 *Smith v. Croft (No. 2)*. See Sections 2.1.3.3 and 2.4.1.3.

408 Companies Bill (218), clauses 263(3)(e) and 263(4).

2.5.2.2 The English model of striking a balance

It is widely acknowledged that under English law the balance favors corporate efficiency over minority protection. The policy of non-judicial interference with business matters is deeply rooted in English law. It is embodied not only in the derivative action, but also in other remedies such as the unfair prejudice remedy and the shareholder's personal right to enforce articles of association. For example, no derivative action is allowed against ratifiable misconduct, the unfair prejudice remedy only applies to gross mismanagement, and there may be no personal rights if the breach of articles is only for 'mere internal irregularities'.

For striking a balance the principal method found in common law is the *Foss* rule and its subsequent development. These rules, however, have laid down significant obstacles for individual shareholders to initiate derivative actions. In addition, judicial oversight also plays a role: the court's permission is needed in order to continue a derivative action. Furthermore, an individual shareholder may have less incentive to initiate a derivative action when allocation of the costs of the action is taken into consideration.

The Companies Bill upholds the traditional attitude towards the derivative action and has no intention of altering the current balance. However, it does repeal the obstacles in traditional common law and totally relies on judicial oversight to strike a balance: the Bill grants the court broad discretion in deciding whether to permit a derivative action. Therefore, the new law is more flexible and perhaps more accessible to the individual shareholder, depending on how the court ends up interpreting 'a *prima facie* case for giving permission'.[409] Actually, the effect of the new law on a shareholder's right to derivative actions will depend on how the court ends up exercising its discretion in granting permission.

409 Companies Bill (218), clause 261(2).

Chapter 3

The United States

3.1 Introduction to American law on derivative actions

3.1.1 Development of American law on derivative actions

American law on derivative actions is quite different from English law, although both of them are common law jurisdictions. In fact, 'The law of business corporations is one area where English and American law differ to a very marked degree'.[1]

As will be seen, the historical development of derivative actions in the United States has shown a tendancy to place more and more restrictions on the shareholder's right to derivative actions. However, regarded as 'the legal equivalent of a cat's nine lives'[2], the derivative action has survived these restrictions and still plays an important role in American corporate governance.[3] In short, the history of the derivative action is 'an expression of the tension between shareholders and management' and as such illustrates the legal response to this tension.[4]

In the following section, I will divide the development of derivative actions in the United States into four stages.

3.1.1.1 The first stage: the origin of American law on derivative actions – an isolated development

When the first line of cases on derivative actions occurred in the United States, there were still no helpful authorities in English law (*Foss v. Harbottle* had not been decided yet. Therefore, American judges had to solve the issue of the minority shareholder's standing in actions against corporate wrongs by themselves. In 1817 *Att.-Gen. v. The Utica Insurance Company*[5] for the first time proposed the possibility of minority shareholders bringing actions against corporate wrongs. *Taylor v. the Miami Exporting Co.* (1831)[6] was the first successful case of this kind of action reported, but it was little noted, perhaps because the

1 Boyle (1965), p. 317.
2 Thompson & Thomas (2004), p. 1749.
3 Thompson & Thomas (2004), p. 1749.
4 Ferrara et al. (2005), Section 1.03.
5 2 Johns Ch. 371, (N.Y. 1817), 1817 WL 1582 (1817).
6 5 Ohio 162 (1831).

principles involved in the issue were not properly discussed.[7] The case which did attract greater attention was *Robinson v. Smith* in the following year[8], where the Chancery Court of New York upheld the shareholder's right to initiate a derivative action on behalf of the corporation.[9] Although the court admitted that generally an action to redress a corporate wrong should be brought in the name of the corporation, it would not allow a wrong to go unredressed simply for the sake of form and therefore decided to allow a derivative action.[10] This shareholder right to derivative actions was firmly supported in the Federal Supreme Court case of *Dodge v. Woolsey* in 1855.[11] In this case, the shareholder's derivative action was allowed against an outsider (the tax collector of the State of Ohio. There was no director's breach of fiduciary duty of loyalty or director's fraud involved.

To summarize, during this period, American courts, isolated and without influence from English law as they were, developed their own rules on derivative actions. They were much more lenient towards minority shareholder's derivative actions than their English colleagues were. They 'were prepared to allow the minority to sue whenever the directors refused to act in clear breach of their duty or, alternatively, whenever it could be shown that the corporation was under the control of the wrongdoers'.[12]

The more lenient approach of the United States towards derivative actions, compared to the English one, may be explained by the background of the derivative action cases. Unlike in England where the principles of company law and relevant litigation procedures, including the *Foss* rule, found their origin in the law on partnerships, in the United States, corporate law, including derivative action rules, developed independently.[13] Therefore, the principles deeply rooted in English company law such as the principle of majority rule and the principle of non-intervention in business matters did not act as obstacles to the American shareholder's right to derivative actions from the outset before the reception of the *Foss* rule.[14] In fact, American courts more or less freely permitted suits by minority shareholders.[15]

Recognition of the dual aspects of derivative actions may also account for the American approach.[16] In *Dodge v. Woolsey*, it was recognized that the derivative action was in fact a combination of two suits: one enforcing the company's rights of action against misconduct; the other enforcing the obligation owed by the

7 See Boyle (1965), p. 322, Footnote 21; Hornstein (1967), p. 284.
8 3 Paige 222 (N.Y.Ch. 1832), 1832 WL 2663 (1832).
9 Boyle (1965), pp. 321-322, Footnote 21; Hornstein (1967), p. 284.
10 3 Paige 222, 223 (N.Y.Ch. 1832), 1832 WL 2663 (1832).
11 18 How. (59 U.S.) 331 (1855).
12 Boyle (1965), p. 322.
13 Hornstein (1967), pp. 283-284.
14 Boyle (1965), p. 323.
15 Hornstein (1967), p. 284.
16 Hornstein (1967), pp.. 284-285.

company to the plaintiff and to all other shareholders in equity.[17] Therefore, the individual shareholder was regarded as having an equitable right to enforce a corporate right of action against the directors or other wrongdoers if the management wrongfully refused to do so.[18] This dual aspect of derivative actions has been generally recognized.[19]

This lenient approach did not mean that during this period the courts were prepared to grant derivative actions without restrictions. In *Dodge v. Woolsey*, the plaintiff shareholder made a request to the board of directors to prevent the alleged corporate wrong. In fact, during this period the need to exhaust intra-corporate remedies had already been emphasized, and it was a rule that prior to filing a derivative action the plaintiff shareholder first had to put a demand to the board of directors.[20] In addition, the minority shareholder was not permitted to bring a derivative action against a mere business judgment of the director. In *Dodge v. Woolsey*, the Supreme Court distinguished breach of trust cases from those cases in which there was 'only error and misapprehension, or simple negligence on the part of the directors'[21]; where there was 'an error of judgment merely,' no liability was permitted to be found.[22] This distinction is regarded as the predecessor of the business judgment rule.[23]

3.1.1.2 The second stage: reception of the English Foss rule in a different form and to a limited extent

3.1.1.2.1 Reception of the English *Foss* rule

The influence of the English *Foss* rule on American law began in the 1870s.[24] In *Brewer v. Proprietors of Boston Theatre*[25], the Massachusetts Supreme Court for the first time clearly stated that in order to justify a derivative action, the plaintiff shareholder 'must show that suitable redress is not attainable through the action of the corporation'.[26] The plaintiff must have applied to the board of directors to bring a corporate action (the demand on the board of directors), and the board must have refused the request. The demand could be excused, however, if it would be futile to do so, such as when 'the directors themselves are the parties charged with the wrong, or by whose fraud or willful collusion the wrong has been

17 *Dodge v. Woolsey* 18 How. (59 U.S.) 331, 341-344 (1855).
18 *Dodge v. Woolsey* 18 How. (59 U.S.) 331, 342-344 (1855).
19 Cox et al. (2001), p. 15.17.
20 Boyle (1965), p. 322; Ferrara et al. (2005), Section 1.03, text accompanying Footnotes 7 & 8.
21 *Dodge v. Woolsey*, 18 How. (59 U.S.) 331, 343-344 (1855).
22 18 How. (59 U.S.) 331, 345-346 (1855).
23 Ferrara et al. (2005), Section 1.03, text accompanying Footnotes 9 to 11.
24 For a detailed discussion of the English *Foss* rule, please refer to Section 2.1.
25 104 Mass. 378 (1870).
26 104 Mass. 378, 386 (1870).

accomplished, and the suit is to be brought against them'.[27] In addition, the Court also acknowledged that shareholders collectively had the power to ratify certain misconduct other than fraud or *ultra vires* act.[28]

The Federal Supreme Court case of *Hawes v. Oakland*[29] was even more strongly influenced by the *Foss* rule and it has been regarded as the equivalent of *Foss v. Harbottle*.[30] In *Hawes v. Oakland*, Justice Miller established both substantive and procedural limitations on the shareholder's ability to initiate derivative actions, which were very similar to those in the *Foss* rule. Substantively, Justice Miller required that the causes of derivative actions had to be restricted to certain areas of misconduct, such as the directors' unauthorized acts, fraudulent transactions, or acts carried out for their own interests which would result in serious injury to the corporation or to other shareholders.[31] In addition, he also set out several procedural requirements for any shareholder who wished to file a derivative action. Firstly, there was the requirement for the plaintiff shareholder to make demands on both the managing board and shareholders as a whole.[32] Secondly, there was the contemporaneous ownership requirement, which required the complainant to be a 'shareholder at the time of the transactions of which he complains, or that his shares have devolved on him since by operation of law'.[33] Thirdly, the plaintiff shareholder also had to establish that 'the suit is not a collusive one to confer on a court of the United States jurisdiction in a case of which it could otherwise have no cognizance'.[34]

Although *Hawes v. Oakland* was obviously influenced by the English *Foss* rule, it still differed from the English rule. The most important difference was that *Hawes v. Oakland* did not simply copy the *Foss* rule into American law, but made demands both on the board of directors and shareholders. Another difference was that the demand requirement, unlike in the *Foss* rule, did not apply to shareholders' direct actions.[35]

Both the substantive and procedural restrictions placed on derivative actions as established by *Hawes v. Oakland* would follow later.[36] One case in point is the subsequent enactment of Equity Rule 94 in 1881, which is the antecedent of the current Rule 23.1 (on derivative actions) of the Federal Rules of Civil Procedure.

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27 104 Mass. 378, 386-387 (1870).
28 104 Mass. 378, 394-398 (1870).
29 104 U.S. (14 Otto) 450, 26 L.Ed. 827 (1881).
30 Griggs & Lowry (1994), p. 477.
31 104 U.S. (14 Otto) 450, 460, 26 L.Ed. 827 (1881).
32 104 U.S. (14 Otto) 450, 460-461, 26 L.Ed. 827 (1881).
33 104 U.S. (14 Otto) 450, 461, 26 L.Ed. 827 (1881).
34 104 U.S. (14 Otto) 450, 461, 26 L.Ed. 827 (1881).
35 Boyle (1965), pp. 324-325.
36 For a detailed discussion of the restrictions placed on derivative actions in current American law, see Section 3.4.

3.1.1.2.2 Developments after *Hawes v. Oakland*

Thus *Hawes v. Oakland* should have had the effect of tightening the American rule on derivative actions. However, the courts of most states later interpreted this case more liberally.[37] This more lenient approach added to the differences between American and English law. For example, those situations which may give rise to derivative actions under the current American law are not limited to the grounds found in *Hawes v. Oakland*. It is generally accepted that shareholders may sue derivatively against a director's breach of duty, subject to the business judgment rule and the demand requirement. The English *Foss* rule, in contrast, only allows derivative actions against fraudulent acts. Moreover, under the American law the demand requirement was also further relaxed by later courts such that a demand on the board of directors may be excused if the alleged wrongdoer controls the board or colludes with the majority on the board, and even in cases where a demand on the board is not excused, the board's refusal to sue may in itself be non-binding if the plaintiff can show the existence of 'wrongful refusal'.[38] In addition, in many states a demand placed on shareholders is no longer required. Even in jurisdictions where the demand on shareholders is still necessary, the demand can be excused in certain situations.[39]

3.1.1.3 The third stage: the security-for-expenses statutes

Until the beginning of the twentieth century, American courts generally took a lenient approach towards derivative actions, especially through their laxity in terms of the demand requirement. This lenient approach led to the popularity of 'strike suits,' which were brought without substantial merits in law or fact, but simply for the benefit of forcing a settlement.[40] By the 1940s the abuse of derivative actions had become a serious problem.[41] In the 1940s the New York Chamber of Commerce formed a special committee on corporate litigation. The committee examined 1,400 derivative actions filed between 1936 and 1942 in New York City and completed its Report (the Wood Report) in February 1944.[42] The Report concluded that the benefits of these actions were normally outweighed by their costs and that derivative actions were abused frequently. It found that, first, the plaintiff shareholders generally were nominal and had no financial interests in pursuing the suits; second, a limited number of attorneys were taking charge of the bulk of the litigation; third, the plaintiff hardly ever won the case; and fourthly, private settlements in which the corporation often received

37 Boyle (1965), p. 325.

38 For a detailed discussion of the demand on the board, please refer to Section 3.4.2.2.2.

39 For a detailed discussion of the demand on the shareholders, please refer to Section 3.4.2.2.3.

40 Boyle (2002), p. 41.

41 Ferrara et al. (2005), Section 1.03.

42 F. Wood, Survey and Report Regarding Derivative Suits, (1944); as cited in ALI (II), Part VII, Chapter 1, Introductory Note, Reporter's Note 1, p. 9.

nothing were common.[43] This Report directly resulted in New York's security-for-expenses statute, which was enacted to 'meet the evil posed by baseless strike stockholders' suits against corporate directors and stockholders'[44], and it was hoped that this statute might deter strike suits.[45] Sixteen states followed New York and enacted security-for-expenses statutes, excluding Delaware.[46] In addition, other methods were also taken to constrain derivative actions, for example, 'common law defenses were tightened, and an extraordinary procedural complexity developed around such questions as jurisdiction, alignment of the parties, demand on the board and shareholders, and settlement and dismissal'.[47]

Initially, adoption of the security-for-expenses statutes was regarded as the death knell for derivative actions.[48] However, in the end these statutes did not have the expected effect. Plaintiffs were able to avoid the application of these statutes by several means, such as by pleading a cause of action under federal law or satisfying the threshold applied by many statutes to exempt such a requirement (for instance, by aggregately holding more than five percent of shares).[49] As a result, by the late 1960s there was a revival of derivative actions.[50] Between 1956 and 1966 the number of reported derivative suits increased significantly compared to the previous decade.[51]

3.1.1.4 The fourth stage: the special litigation committee

Because the security-for-expenses statutes scarcely played any role in preventing or reducing strike suits, and because by the mid-1970s the American economy had begun to grow, the balance between corporate efficiency and the protection of minority shareholders was reconsidered. This led to the development of a new strategy for controlling the abuse of derivative actions. A special litigation committee of the corporation, which was composed of independent directors, could terminate a derivative action on the grounds that the action would not be in the best interests of the corporation even if the derivative action was against other directors of the corporation. This strategy, first applied by the Federal District

43 F. Wood, Survey and Report Regarding Derivative Suits, (1944), p. 32; as cited in ALI (II), Part VII, Chapter 1, Introductory Note Reporter's Note 1, p. 9; also see Ferrara et al. (2005), Section 1.03.

44 *Roach v. Franchises International, Inc.*, 32 A.D.2d 247, 249, 300 N.Y.S.2d 630, (1960); also see Ferrara et al. (2005), Section 1.03, Footnote 26.

45 *Roach v. Franchises International, Inc.*, 32 A.D.2d 247, 250, (1960); also see Ferrara et al. (2005), Section 1.03, Footnote 27.

46 Ferrara et al. (2005), Section 1.03.

47 F. Wood, Survey and Report Regarding Derivative Suits, (1944), p. 32; as cited in ALI (II), Part VII, Chapter 1, Introductory Note, Reporter's Note 1, p. 9.

48 Ferrara et al. (2005), Section 1.03, text accompanying Footnote 28.

49 ALI (II), Part VII, Section 7.04, Comment H, pp. 90-91.

50 Coffee & Schwartz (1981), pp. 261-262.

51 Dykstra (1967).

Court of New York in *Gall v. Exxon Corp.*[52], and later by the Federal Supreme Court in *Burks v. Lasker*[53] and the New York Court of Appeals in *Auerbach v. Bennett*[54], was accepted in the early 1980s by many courts in various states. Although these states took varied approaches towards it, this strategy of the special litigation committee has indeed provided a substantial obstacle to a shareholder's right to initiate a derivative action.[55]

3.1.1.5 Recent developments

In recent years there has been no substantial reform of derivative actions. However, due to the apparent abuses in securities litigations and corporate scandals such as Enron, there have been reforms aimed at several aspects of corporate governance. These reforms, although they do not regulate derivative actions directly, may have certain effects on derivative actions. An example is the enactment of the Sarbanes-Oxley Act (the SOX) in 2002. The SOX was enacted in response to a series of corporate scandals. Major measures adopted include strengthening the directors' and officers' liabilities, ensuring auditor independence, and creating a board of independent accounting overseers. Although the SOX has nothing to do with derivative actions directly, it may have an indirect effect on derivative action in several ways.[56] First, the SOX extends the statute of limitations for civil suits for violations of federal securities laws from one year after discovery or three years after the disputed transaction to two years after discovery or within five years after the disputed transaction.[57] These extensions provide additional time for the aggrieved shareholder to initiate derivative actions. Second, the requirements on lawyers to report any potential material violation of securities law or a breach of fiduciary duties may provide an opportunity for discovery for plaintiffs in derivative actions.[58] Third, the SOX also improves the role of independent directors and committees of independent directors and tries to provide better *ex ante* mechanisms for disciplining corporate management and so, if they should prove successful, could well make derivative actions less important.[59]

52 418 F Supp 508 (United States District Court, SDNY, D.C.N.Y. 1976).
53 441 U.S. 471 (1979).
54 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (N.Y. 1979).
55 For the details about the special litigation committee, see Section 3.4.2.2.2.3.3.
56 For the effects, see Ferrara et al. (2005), Section 1.05.
57 Sarbanes-Oxley Act, s 804, 28 U.S.C. s 1658.
58 Sarbanes-Oxley Act, s 307, 15 U.S.C. s 7245.
59 For the improvement, such as the requirements for the changes in board composition, especially the requirement for an independent accounting oversight board; see Sarbanes-Oxley Act, ss 201-206, 15 U.S.C. ss 78c(a), 78f, 78j-1.

3.1.2 Methodology of research

Derivative actions in the United States are governed both by state law and federal law. Although the law on derivative actions varies from state to state, some general rules may be identified. I would now like to focus on these general rules.

To do so, I will need to pay special attention to Delaware law, as well as rules suggested in the American Law Institute (ALI)'s Principles of Corporate Governance: Analysis and recommendations (hereinafter 'the ALI Principles')[60] and the Model Business Corporation Act (hereinafter 'the MBCA'). As we know, Delaware is regarded as the American corporate center and its corporate law has assumed a dominant position.[61] The ALI Principles recommend what good corporate practice should be and the MBCA offers guidance in the development of corporate law. Although neither of them are law, the ALI Principles and the MBCA certainly have an impact on where the law may go and, therefore, are useful in analyzing American law.[62]

3.2 The role of derivative action in the United States

3.2.1 A more important role in the United States than in England

Although its role has varied for different periods in the United States, the derivative action has continuously played a more important role there than in England. Hornstein lists some factors which may account for this difference: major legal principles, traditional practices and ethical standards of the legal profession.[63]

To begin with, those legal principles favored in American law may explain the American approach to derivative actions. In corporate law there are two lines of principles which may conflict with each other: one line is comprised of the principles of corporate entity and corporate self-government through majority rule, while the other line follows the principle of protecting the interests of corporations and minority shareholders. Where the two lines of principles conflict, American law has always been ready to disregard the corporate entity in order to prevent injustice, since equity 'never permits a wrong to go unredressed merely for the sake of form'.[64] This approach is different from the English one, which as mentioned in Chapter 2 favors more the first line of principles. This

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60 American Law Institute, *Principles of Corporate Governance: Analysis and recommendations,* St. Paul, Minnesota: American Law Institute Publishers (1994).

61 See, for example, Ferrara et al. (2005), Section 2.02, text accompanying Footnote 1.

62 Cox et al. (2001), pp. 2.26-2.28; Lockwood & Barsch (1996), pp. 610-611.

63 Hornstein (1967), p. 282.

64 *Robinson v. Smith,* 3 paige Ch, 222, 233 (N.Y. 1832). Also see Hornstein (1967), pp. 282-283, p. 286.

difference may be due to the historical development of each system of law. As mentioned in Section 3.1.1.1, American law on derivative actions originally developed from the pure corporate form, while the English *Foss* rule grew out of the law on partnerships.[65] In addition, as early as in the case of *Dodge v. Woolsey*, the dual aspects of derivative actions had been recognized. Therefore, from the very beginning there were fewer limitations on granting minority shareholders the right to initiate derivative actions under American law. Although later the United States did introduce the English *Foss* rule, it still took a form that was different from and less strict than the English *Foss* rule.[66]

The willingness to grant relief to minority shareholders in the United States has traditionally resulted in lenient rules regarding a shareholder's right to derivative actions. For example, the restrictions on the shareholder's right to bring a derivative action were less strict and so derivative actions could be applied widely. In fact, derivative actions in the United States were originally 'the earliest and principal constraint on director mismanagement'.[67] They could even be applied in disputes that did not arise from corporate mismanagement.[68] Although later development has brought about a stricter approach towards them and as a result their role has been in decline, derivative actions still play a relatively important role.

The third reason for the popularity of derivative actions in the United States may be the contingency fee arrangement. Unlike in England, the contingency fee arrangement is widely accepted and is also applied to derivative actions. This allocation of litigation costs is regarded as contributing to the popularity of derivative actions.[69]

Hertig and Kanda raise other factors which may account for the popularity of litigation in the enforcement of fiduciary duty in the US.[70] For example, with regard to the conflict between shareholders and directors, because in England institutional investors tend to form voting alliances and in continental Europe ownership of public corporations is generally concentrated as well, shareholders in such countries are more likely to have non-judicial methods for disciplining management. In the US, however, due to the widely scattered share structure, litigation is the main method for shareholders to control management.[71] Another example is that it is generally acknowledged that in the US private enforcement

65 Hornstein (1967), pp. 283-284.

66 Boyle (1965), p. 323.

67 Thompson & Thomas (2004), p. 1756.

68 For example, in *Dodge v. Woolsey*, 18 How. (59 U.S.) 331, (1855), the action was against the tax collector of the State of Ohio and therefore did not involve an intra-corporate dispute. In this case, the derivative action was brought in order to avoid the jurisdiction of the State court and to seek federal jurisdiction. For a detailed discussion of the wider scope of application for this, see DeMott (2003), Sections 1:3 & 1:4.

69 For a detailed discussion of the contingency fee arrangement, please see Section 3.4.4.2.

70 Kraakman et al. (2004), pp. 116-118.

71 Kraakman et al. (2004), p. 117.

is more favored than in other countries, while public enforcement finds relatively little favor.[72] In England, public enforcement, on the other hand, plays an important role.[73] Furthermore, other factors such as business ethics and possible compensation awarded by the court may also affect the popularity of litigation.[74]

3.2.2 *A less important role nowadays than in the past*

For a long time after its origin, the derivative action was a recognized form of litigation and was considered 'the chief regulator of corporate management'.[75] However, as seen from the historical development of derivative action, for the last half century the attitude towards derivative action and its function has changed. In fact, since the early 1980s the derivative action has played a less important role in corporate governance than in earlier days.[76]

The decline in the role of derivative actions is a direct result of the restrictions on derivative actions, both substantive and procedural, which were added later, as mentioned in Section 3.1.1. These additional restrictions are mainly due to the bad reputation of derivative actions. Moreover, economic growth by the 1970s had also resulted in a reconsideration of the balance between the corporate entity (and corporate efficiency) and protection for minority shareholders.[77] As a result, the shareholder's right to derivative actions was restricted.

The decline of the role of derivative actions may also be a result of the development of other mechanisms. Until the early 1980s, there were few effective alternative corporate governance mechanisms. For example, scarcely any market for corporate control existed, and shareholder voting was generally regarded as ineffective.[78] Derivative actions were the principal method for disciplining corporate management. However, after the 1980s other mechanisms, both *ex ante* and *ex post*, developed, so that there may now be less need for derivative actions. For example, particularly in the early 1980s, the development of the market for corporate control provided a real alternative to litigation as a method of disciplining corporate management.[79] In particular, the requirement by American stock exchanges for more independent directors for large public corporations and the development of large institutional investors may have provided *ex ante* control of corporate management. In fact, not only law, but also private ordering and

72 Eviatar (2002). Also see Section 1.4.

73 Kraakman et al. (2004), p. 117. See Section 2.2.1.

74 Kraakman et al. (2004), p. 118.

75 *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 548 (1949). Coffee & Schwartz (1981), p. 261.

76 Growth of derivative actions still continued in the 1960s; Dykstra (1967), p. 74.

77 Cox (1999), pp. 3-4.

78 Thompson & Thomas (2004), p. 1756.

79 Thompson & Thomas (2004), p. 1756.

norms have provided mechanisms for strengthening 'the roles of various gatekeepers who affect corporate governance'.[80]

In the case of close corporations, American legislatures and courts have developed special mechanisms to solve corporate governance problems. These special mechanisms, at least to a certain extent, have succeeded in making the derivative action less important in close corporations than in public corporations. I will discuss this issue further in the following section.

3.2.3 A more important role in public corporations than in close corporations

3.2.3.1 Classification of close corporations and public corporations

Traditionally, different states had their own single corporate statute which was applicable to all corporations. Also most case-law doctrines were uniformly applicable to all corporations.[81] These uniform statutory and judicial rules and norms usually reflected the needs of publicly held corporations and were suitable for them.[82] However, in recent years there has been a trend toward recognizing the distinctive features of close corporations and developing rules and norms specifically suitable for these close corporations.

3.2.3.1.1 The distinction between close and public corporations

Corporations are generally divided into public corporations (or publicly held corporations) and close corporations (or closely held corporations).[83] Nevertheless,

80 Thompson & Thomas (2004), pp. 1756-1757.

81 ALI (I), Introductory Note to Parts III and III-A (Structure of the Corporation), p. 79.

82 Thompson (1993), p. 700; Eisenberg (2000), p. 349; O'Kelley & Thompson (1999), p. 453.

83 But see the different classification by the ALI. The ALI divides the corporations into 'closely held corporations' and 'publicly held corporations.' However, the two types of corporation are not reciprocal; see ALI (I), Sections 1.06 and 1.31. S1.06 defines 'closely held corporation' as 'a corporation the equity securities of which are owned by a small number of persons, and for which securities no active trading market exists.' S1.31: '"Publicly held corporation" means a corporation that as of the record date for its most recent annual shareholders' meeting had both 500 or more record holders of its equity securities and $5 million or more of total assets; but a corporation shall not cease to be a publicly held corporation because its total assets fall below $5 million, unless total assets remain below $5 million for two consecutive fiscal years.' In addition, for the purpose of Parts III and III-A (structure of the corporation), ALI adopts a three-tier division of corporations. The first tier is 'large publicly held corporations' which consist of corporations with at least 2,000 record holders of equity securities and $100 million of total assets. The second tier is 'small publicly held corporations' which consist of corporations, other than the first-tier corporations, with at least 500 record holders of equity securities and $5 million of total assets. The third tier consists of very different types of corporations including closely held corporations and corporations that are publicly held for many functional purposes with more than 50-100 but fewer than 500 shareholders. See ALI (I), Introductory Note to Parts III and III-A (Structure of the Corporation), pp. 79-81.

there are neither legal definitions nor unanimously agreed definitions for these two types of corporation. Generally speaking, close corporations are identified by several features: they only have a few shareholders[84]; their shares cannot be publicly transferred since there is no public market for the shares; in many close corporations, shareholders have entered into agreements to restrict the transferability of shares[85]; they are normally managed by the shareholders, and so on.[86] Although different definitions may emphasize different features, most close corporations have most, if not all, of these features. In contrast, public corporations normally have a larger number of shareholders and their shares can be publicly traded on the national securities exchanges.[87] In addition, ownership and management of public corporations are normally separate. Of course, there are many 'in between' corporations that have some characteristics of both public corporations and close corporations, such as a corporation which has a substantial number of shareholders but whose shares are infrequently or 'sparsely' traded.[88] However, these 'in between' corporations do not affect the basic classification.

The major agency problem in close corporations is different from that in public corporations due to their differing features. In public corporations, the major agency problem is between shareholders and directors; due to widely spread shareholding in public corporations, disputes among shareholders are not the primary problem in the United States. However, in close corporations the major agency problem is normally between majority and minority shareholders, since therein, managers and shareholders are normally identical and the close corporation, on the level of both the general meeting of shareholders and the board of directors, is generally controlled by majority shareholders due to the application of the majority rule principle. In addition, in close corporations 'the distinction between the interests of the corporation as an entity and interests of its shareholders may seem more formal than real'[89], therefore, where corporate interests have been infringed upon, the real dispute lies between shareholders rather than between the controlling wrongdoer and the corporation.

Another distinction between close and public corporations is that it is normally more difficult for the aggrieved shareholder in a close corporation to exit the corporation, due to the lack of public markets for these shares and the restriction on the transferability of shares. This may lead to the concern that different legal remedies may be necessary for shareholders in close corporations.

84 This is typically defined as less than 25; Rock & Wachter (1999), p. 913, Note 1.
85 Hamilton (2000), p. 2.
86 Hamilton (2000), p. 2, pp. 343-344.
87 Hamilton (2000), p. 2, pp. 376-377.
88 Hamilton (2000), p. 3.
89 DeMott (2003), pp. 2-34 – 2-35.

3.2.3.1.2 Different treatment for close corporations

Due to the distinctions between close and public corporations, the traditional corporate norms, which usually reflect the needs of public corporations, especially large public corporations, may be unsuitable for close corporations.[90] This inappropriateness of one general corporate law has been gradually recognized and new norms specifically applicable to close corporations have been developed over the last twenty-five to thirty-five years.[91] On the one hand, case law has developed new rules for close corporations, for example, the power of the participants in close corporations to contract out of the statutory rules has been greatly extended[92], remedies which are only available to minority shareholders in close corporations have been developed[93], and special criteria to distinguish between direct and derivative actions have been established.[94] In addition, separate legislation specifically applicable to close corporations has been enacted in some states. However, these special close corporation statutes have not been widely applied in practice.[95] Therefore, I will not be paying special attention to them.

3.2.3.2 Empirical study of the role of derivative action

In the United States derivative actions are filed against both public and close corporations. Unlike the rare application of derivative actions in public companies in England, in the United States derivative actions play a more important role in public corporations than in close corporations. This can be shown by a recent empirical study carried out by Thompson and Thomas.[96] They made a detailed study of all corporate litigation in Delaware from 1999 to 2000. According to their study, during the two-year period, there were 137 derivative action complaints, among them eighty percent (108) were filed against public companies with the remaining twenty percent (26) against close companies[97], including close corporations, limited partnerships, a mutual company and a limited liability company.[98] Among the cases against close companies[99], only one-third were granted affirmative relief, while almost half were dismissed without

90 Thompson (1993), pp. 700-702.
91 For example, Thompson (1993), p. 704.
92 Rock & Wachter (1999), p. 914.
93 Rock & Wachter (1999), p. 923. For a detailed discussion of the remedies, please refer to Section 3.2.3.4.
94 For details, see Section 3.3.3.
95 Hamilton (2000), p. 359.
96 Thompson & Thomas (2004).
97 Thompson & Thomas (2004), p. 1762, Table 3.
98 Thompson & Thomas (2004), p. 1764.
99 Since one transaction generated two suits there were actually twenty-five cases; see Thompson & Thomas (2004), p. 1764.

relief.[100] Therefore, the authors concluded that 'private company derivative litigation in Delaware plays little role in the governance of these firms'.[101]

One question about Thompson and Thomas's study is whether the statistics on Delaware cases represent the role of the derivative action throughout the United States. The answer should be positive as far as public corporations are concerned due to the dominance of Delaware corporate law in public corporations and the popularity of Delaware as a state where public corporations choose to incorporate.[102] However, we should not answer the question so quickly with regard to close corporations. In fact, regarding close corporations Delaware does not have the same dominant position as it does regarding public corporations; its share of total non-public incorporations is less than three and a half percent.[103] Besides, Delaware's law on close corporations is different from that of most other states.[104] In fact, Delaware's law provides fewer remedies for aggrieved minority shareholders in close corporations than do other states. For example, the commonly available remedy of oppression is not recognized in Delaware; there is no involuntary dissolution statute in Delaware either; unlike a majority of states, Delaware also does not allow the court discretion to treat a derivative action as a direct one where a derivative action is not necessary.[105] On the contrary, shareholders in Delaware are more often expected to protect themselves by contractual agreements. The limited options for litigation by minority investors in close corporations should have resulted in a more important role for derivative actions in Delaware[106], yet this has not been the cases as is shown by the study. The researchers also regard this fact as a 'puzzle'.[107] They surmise that the reasons might lie in the fact that the aggrieved minority shareholders preferred direct actions to derivative actions or relied more on contractual agreements, or there were simply relatively few close corporations in Delaware.[108]

No empirical study on the derivative action's role in close corporations in other states has yet been conducted to my knowledge.[109] However, it is generally accepted that in most states there is a trend toward recognizing the distinctive features of close corporations and developing new corporate governance strategies for minority shareholders in close corporations. These new strategies,

100 Thompson & Thomas (2004), pp. 1766-1767, Table 6.
101 Thompson & Thomas (2004), p. 1767.
102 Thompson & Thomas (2004), p. 1760.
103 Thompson & Thomas (2004), p. 1763.
104 Thompson & Thomas (2004), pp. 1763-1764.
105 DeMott (2003), Section 2:5, p. 2-35.
106 Thompson & Thomas (2004), p. 1792.
107 Thompson & Thomas (2004), p. 1792.
108 Thompson & Thomas (2004), p. 1785, p. 1792.
109 In fact, there is far less research on the derivative action against close corporations than there is against public corporations. Robert B. Thompson and Randall S. Thomas also pointed out that 'the academy has virtually ignored derivative suits against private companies.' Thompson & Thomas (2004), p. 1760.

especially the minority shareholders' new causes of direct action against misconduct (the mechanism of broadened involuntary dissolution and the mechanism of enhanced fiduciary duties owed by a shareholder to others), provide better protection for minority shareholders and may be undervaluing the role of the derivative action in close corporations. I will discuss this trend in detail in the following sections.

3.2.3.3 Different corporate governance strategies in close corporations

As mentioned above in Section 3.2.3.1.1, close corporations have their own features that are different from those of public corporations. Due to these differences, mechanisms that deal with corporate governance issues in public corporations may not be functional in close corporations. For example, there is no market force to discipline corporate management in close corporations; the close corporate structure also makes it difficult for close corporations to adopt the mechanism of independent directors. The derivative action, as it is structured in American law, may also be ill-suited to close corporations. There are two possible reasons for this. First, if it is directed against the controlling shareholders in close corporations, a derivative action may have problems. For example, the nature of the derivative action requires that the recovery, if awarded, be paid to the corporation. However, since it is difficult to expel the wrongdoing majorities from the company or to eliminate their controlling power, the recovery awarded to the injured company would still be under their control. Besides, they would also indirectly benefit from the recovery based on the shares they owned. Thus, the function of compensation and deterrence found in a derivative action might not be workable. Second, the procedural restrictions on derivative actions for preventing strike suits hardly play any role in close corporations[110] and the risk of strike suits is less serious due to the greater stake of the plaintiff shareholder in the action. As a result, many jurisdictions have modified their statutory and judiciary norms and developed mechanisms specifically for close corporations. These mechanisms may end up reducing the conflict among shareholders in close corporations. For example, the greater freedom to make contractual agreements among shareholders *ex ante* may make the problem of oppression by majority shareholders less severe than it might have been before.[111]

Of course, a detailed discussion of the mechanisms applied in close corporations is not our aim here. Nevertheless, we should pay attention to the mechanisms which may affect the function of derivative actions in close corporations. The most important mechanisms which may undermine the function of derivative

110 This is why the court is more likely to excuse demand in close corporations where it is difficult to find a disinterested and independent party; see Thompson & Thomas (2004), p. 1767.

111 Hamilton (2000), p. 350.

actions may be the mechanism of broadened involuntary dissolution and the mechanism of enhanced fiduciary duties owed by the controlling shareholder to other shareholders. These mechanisms allow the aggrieved minority shareholders in close corporations to bring actions against the wrongdoer directly.[112] Actually these recently developed causes of direct action may not only provide new remedies for minority shareholders against the majority shareholder's oppression that they did not have before, but may also give minority shareholders the right to initiate (procedurally simple) direct actions in the case of corporate wrongs under circumstances where in public corporations only (procedurally complex) derivative actions could be initiated.[113] Therefore, in close corporations the minority shareholders' right to initiate direct actions and the right to derivative actions may overlap. Although the minority shareholders who initiate direct actions against corporate misconduct may not recover their reflective loss[114], and although the plaintiff of a direct action cannot recover lawyers' fees from the corporation[115] while a successful plaintiff in a derivative action can[116], a direct action may still be more attractive for minorities than a derivative action because these minorities can avoid the substantive and procedural hurdles of the derivative action and benefit directly from the remedies. These causes of direct action have become especially attractive recently now that legislatures and the courts have broadened the circumstances to which the remedies may apply and have expanded the range of remedies, showing a tendency to provide better protection for minority shareholders in close corporations.[117]

In the following section, I will briefly discuss those recently developed mechanisms which grant causes of direct action to individual shareholders in close corporations: the mechanism of broadened involuntary dissolution and the mechanism of enhanced fiduciary duties owed by the controlling shareholder to others.

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112 But in Delaware where there are no rules similar to the 'oppression' remedy or the heightened fiduciary duties of the majority shareholders, the derivative action still plays a less important role in close corporations than in public corporations; see Thompson & Thomas (2004). The authors cannot find a good explanation for this and admit that 'the small number of derivative lawsuits presents something of a puzzle,' Thompson & Thomas (2004), at p.1792. For this unimportant role in Delaware, see Section 3.2.3.2.

113 This in fact blurs the traditional distinction between direct and derivative actions in close corporations. For a more detailed discussion of the distinction, please refer to Section 3.3.3.

114 For details of the remedies under direct action, please refer to Section 3.2.3.4.

115 Thompson (1993), p. 732.

116 See Section 3.4.4.1.

117 Thompson (1993); Rock & Wachter (1999), p. 923.

3.2.3.4 *The new causes of shareholders' direct action in close corporations: remedies against the majority shareholder's oppression*

3.2.3.4.1 Introduction

Improper exercise of the majority shareholder's control, which is also known as the majority shareholders' oppression of minorities, is a major problem in close corporations. The majority's oppression may take many forms, such as termination of the minority's employment in the corporation, unequal treatment of the minority, overcompensation for majority shareholders, and misappropriation of corporation assets by the majority shareholders for their own benefit. Some misconduct, such as the breach of an agreement, undoubtedly gives rise to the causes of shareholders' direct action. Nevertheless, some misconduct may give rise to difficulties in identifying causes of action. For example, misconduct, such as the majority's misappropriation of corporate assets or overcompensation for the majority shareholder, *prima facie* causes injury to the corporation and gives rise to a corporate cause of action, however, it may also give rise to a shareholder individual cause of action in close corporations.

Generally, two mechanisms have been developed to provide minority shareholders with direct remedies (causes of direct action) against the majority shareholders' 'oppression': the mechanism of broadened involuntary dissolution and the mechanism of enhanced fiduciary duties owed by a shareholder to others.[118] These two mechanisms, although not directly connected, both 'reflect the same underlying concerns for the position of minority shareholders, particularly in close corporations after harmony no longer reigns'.[119] For example, the standards used by some courts to define 'oppression' in the involuntary dissolution remedy are the same as the standards used by some courts to determine breach of fiduciary duty.[120] 'Their purposes and effects ... are so sufficiently similar that it makes sense to think of them as two manifestations of a minority shareholder's cause of action for oppression'.[121]

Nevertheless, these two mechanisms do exist separately and should not be confused. Neither of the mechanisms is used by all states.[122] The common law remedy of fiduciary duty is mainly developed in states where the statutory remedy of broadened involuntary dissolution is not available.[123] In states where

118 The principle of involuntary dissolution is also a major way to solve the problem of deadlock in close corporations, but this is beyond the scope of our discussion.
119 Thompson (1993), p. 739.
120 Thompson (1993), p. 700, pp. 711-712.
121 Thompson (1993), p. 700.
122 Thompson (1993), pp.738-739.
123 Thompson (1993), p. 739.

both of them do exist, there are still differences in their application, such as the right to a jury trial, punitive damages, attorney's fees, and the exclusiveness of the statutory remedy.[124] In fact, the specific facts of a case may find that one remedy is more appropriate than another. In the following sections, I will discuss them in turn.

3.2.3.4.2 The broadened involuntary dissolution remedy: the statutory remedy of oppression

Nowadays, the statutes of each state provide minority shareholders in close corporations with the remedy of receivership or involuntary dissolution in one or more specific situations.[125] Among them, most states (39) include 'oppression' or a similar term such as 'unfair prejudice' as a ground for dissolution in their involuntary dissolution statutes, in addition to the grounds of illegality, fraud, misapplication of corporate assets, or waste of corporate assets.[126] These grounds for involuntary dissolution provide the aggrieved minority shareholders in a close corporation with a much wider opportunity for relief and show that attention has been paid to the interests of individual minority shareholders as well as shareholders as a group.[127]

As a ground for involuntary dissolution, oppression was first introduced by the Illinois and Pennsylvania corporations acts in 1933.[128] Originally 'oppression' was interpreted narrowly and this statutory remedy was not widely applied, partly because of the extreme remedy of dissolution and the court's traditional reluctance to dissolve a going concern.[129] Nevertheless, for the last twenty to thirty years, the remedy of involuntary dissolution for oppression has been broadened in two respects: the grounds for judicial dissolution have been broadened (a broadened interpretation of 'oppression'), and the range of remedies has been broadened as well (a wide range of remedies other than dissolution). Due to the broadened grounds and remedies, the original dissolution remedy has turned into

124 Thompson (1993), pp. 739-345.

125 Such as deadlock, illegality, fraud or oppression. See Hamilton (2000), p. 369. For the purpose of this book, I only discuss the situation of oppression.

126 O'Neal & Thompson (2004), Section 9:27: 'Relief based on oppression or similar conduct; statutes listing broad grounds for relief', Footnote 6 and accompanying text. The remaining states can be classified into three types: first, 'states which list illegality or fraud (but not oppression) as grounds for dissolution'; second, 'statutes which only list deadlock as grounds for shareholder action'; and third, 'states in which minority shareholders in most corporations have no statutory grounds to seek dissolution. Delaware, Kansas, and Oklahoma statutes provide no grounds for involuntary dissolution except in corporations that have two shareholders each owning 50 percent.' Id., Footnote 6.

127 O'Neal & Thompson (2004), Section 9:27: 'Relief based on oppression or similar conduct; statutes listing broad grounds for relief.'

128 Thompson (1993), p. 709.

129 Thompson (1993), p. 709.

a general remedy for the aggrieved shareholders, which actually rarely results in the dissolution of the corporation nowadays.[130] In fact, it has become the principal relief for aggrieved minority shareholders in close corporations.[131]

A broadened interpretation of 'oppression'

As mentioned, the grounds for judicial dissolution have recently been broadened. In other words, the interpretation of 'oppression,' which may give rise to the involuntary dissolution remedy, has been widely broadened. 'Oppression' is a general term referring to abusive tactics for controlling shareholders or directors. Sometimes other terms such as 'freeze-outs' or 'squeeze-outs' or 'unfair prejudice' are used.[132] 'Oppression,' or these alternative terms, does not necessarily mean 'illegality' or 'fraud.' It may be identified even where there is an absence of mismanagement or misapplication of assets.[133] Usually there is no statutory definition of 'oppression'.[134] Nevertheless, courts have developed three principal approaches for defining 'oppression,' none of which are exclusive, and sometimes they are applied in combination.[135] The first approach defines 'oppression' as 'burdensome, harsh and wrongful conduct ... a visible departure from the standards of fair dealing and a violation of fair play on which every shareholder who entrusts his money to a company is entitled to rely'.[136] The second approach relates 'oppression' to the enhanced fiduciary duties owed by a shareholder to other shareholders[137], which I will discuss below. The third approach links 'oppression' to the frustration of the reasonable expectations of the shareholders.[138] Whatever the definition of oppression, we should remember that injuries to the corporation, such as misappropriation of corporate assets or waste of corporate assets, are also generally recognized as oppression and thus may give rise to a shareholder's individual right to the remedy for oppression.[139]

The broadened range of remedies

Once 'oppression' has been established, the traditional remedy has been dissolution of the corporation. However, as dissolution of the corporation is an unusual solution and since the court normally will only use so drastic a remedy

130 Thompson (1993), pp. 708-709.
131 Thompson (1993), p. 708.
132 Hamilton (2000), p. 365; Thompson (1993), p. 709, Footnote 70.
133 O'Neal & Thompson (2004), Section 9:27: 'Relief based on oppression or similar conduct; statutes listing broad grounds for relief,' text accompanying Footnote 9.
134 Thompson (1993), p. 711.
135 Thompson (1993), pp. 711-719.
136 *Fix v. Fix Material Co., Inc.*, 538 S.W.2d 351, 358 (Mo. Ct. App. 1976).
137 *Kisner v. Coffey*, 418 So. 2d 58, 61 (Miss. 1982), *Baker v. Commercial Body Builders, Inc.*, 507 P.2d 387 (Or. 1973); see Thompson (1993), p.712.
138 Thompson (1993), p. 712.
139 Thompson (1993), p. 708.

in very exceptional circumstances, the current trend is that a wider range of remedies may be awarded such as buyouts, appointment of a custodian or a provisional director, altering provisions of the constitution, or directing or prohibiting acts of the corporation, its shareholders, directors or officers.[140] In many states, the availability of alternative remedies is actually authorized by the statutes.[141] Even in the absence of specific statutory authorization, the courts are still more willing to grant alternative remedies rather than the remedy of dissolution.[142]

Valuation of the shares in buyouts

The most common remedy for oppression is a buyout of the petitioning shareholder's shares.[143] However, buyouts raise the difficult problem of how to value the shares. In fact, there still is no clear solution to this problem. It is generally agreed, though, that the buyout price should be the 'fair value' of the shares.[144] However, the buyout statutes fail to define 'fair value.' Many courts apply the standard of valuation applied in appraisal right cases, which is unfortunately not clear either.[145] Due to the lack of authority, different opinions exist as to what 'fair value' is. The two major conflicting opinions are, first, the 'fair market value' which reduces or discounts the price of shares that lack control or other valuable

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140 See Section 14.34 of the MBCA; Lockwood & Barsch (1996), p. 641. For a detailed discussion of the alternative remedies, see Thompson (1993), pp. 718-726.

141 Such as Arizona, Illinois, Michigan, Montana, and so on; see Thompson (1993), p. 720, Footnote 142.

142 See, for example, *Orchard v. Covelli*, 590 F. Supp. 1548 (W.D. Pa. 1984), aff'd, 802 F.2d 448 (3d Cir. 1986); *Belcher v. Birmingham Trust Nat'l Bank*, 348 F. Supp. 61 (N.D. Alabama 1968); *Alaska Plastics, Inc. v. Coppock*, 621 P.2d 270 (Alaska 1980); *Sauer v. Moffitt*, 363 N.W.2d 269 (Iowa Ct. App. 1984); *Maddox v. Norman*, 669 P.2d 230 (Montana 1983); *McCauley v. Tom McCauley & Son, Inc.*, 724 P.2d 232 (N.M. Ct. App. 1986); *Delaney v. Georgia-Pacific Corp.*, 564 P.2d 277 (Oregon 1977); *Baker v. Commercial Body Builders, Inc.*, 507 P.2d 387 (Or. 1973); *Davis v. Sheerin*, 754 S.W.2d 375 (Texas Ct. App. 1988); *Contra, Corlett, Killian, Hardeman, McIntosh & Levi, P.A. v. Merritt*, 478 So.2d 828 (Florida Dist. Ct. App. 1985); see Thompson (1993), pp. 720-721, Footnote 144.

143 Moll (2004), p. 308.

144 See, for example, MBCA Section 14.34(a) ('In a proceeding under Section 14.30(2) to dissolve a corporation... the corporation may elect or, if it fails to elect, one or more shareholders may elect to purchase all shares owned by the petitioning shareholder at the fair value of the shares.'); see also Model Statutory Close Corp. Supp. § 42(b)(1) (stating that a court, if it orders a share purchase, should 'determine the fair value of the shares, considering among other relevant evidence the going-concern value of the corporation'). The buyout statutes of several large states and the courts in the states without statutory authorization for a buyout remedy also require the buyout price be the 'fair value' of the shares; see Moll (2004), p. 310.

145 Moll (2004), pp. 310-311; Henderson (1995), pp. 217-223. In *Weinberger v. UOP, Inc.*, 457 A.2d 701, (Del., 1983), the Delaware Supreme Court also applied the valuation method in the dissenter's right case to a non-dissenter's right situation.

attributes; second, 'the net asset value' or the 'enterprise value' which ascribes to each share its *pro rata* portion of the overall enterprise value without discount.[146]

A question that relates to our research is whether the fair price in buyouts should reflect the petitioning shareholder's reflective losses which arose from the injury done to the corporation by the oppressive conduct. If the petitioning shareholder can claim for the reflective loss, the position of derivative actions may be even weaker, as it is in England.[147] However, there is neither legislative nor judicial opinion on this issue.

As to whether these reflective losses will be considered in appraisal right cases, American courts and legislatures have had differing opinions. In *Gonsalves v. Straight Arrow Publishers, Inc.*, where no derivative action was initiated against overcompensation, the Delaware Supreme Court agreed with the lower court that in an appraisal proceeding such a loss should not be considered when valuing the dissenter's shares.[148] In *Sieg Co. v. Kelly*[149], the Supreme Court of Iowa took the same approach as the Delaware Supreme Court. In this case it held that the claims against pre-merger mismanagement and breach of fiduciary duty, which resulted in the injury to the corporation and then depreciated the value of the shares, should be presented in a separate action and so were not appropriately considered in an appraisal action: 'only if the trial court had decided the depreciation resulted from the anticipated merger, and therefore would normally be excluded from consideration, should it have gone on to consider whether exclusion of the depreciation would be inequitable'.[150]

Nevertheless, there is also another line of cases. In Indiana, where the statute provides that the appraisal right remedy should be exclusive and therefore no derivative action will be allowed after the dissenter's rights have arisen[151], the Court of Appeals of Indiana in *Young v. General Acceptance Corp.*, 'affords the dissenter the opportunity not only to have the fair value of his or her shares to be determined, but also to argue any breach of fiduciary duty or fraud claims' in the appraisal proceeding.[152]

We should note, however, that the opinions in the appraisal right cases may not explain the buyout situations since the two remedies have different grounds. As mentioned in *Sieg Co. v. Kelly*:

146 Moll (2004), pp. 311-314.
147 See Section 2.2.2.
148 701 A.2d 357, 363 (Del Super 1997).
149 568 N.W.2d 794 (Iowa 1997).
150 568 N.W.2d 794, 802 (Iowa 1997).
151 Indiana Code section 23-1-44-8(c).
152 738 N.E.2d 1079, 1089 (Ind App 2000).

> An appraisal action is not an equitable proceeding wherein the court assigns a value to the dissenters' stock that it considers 'fair and equitable under all the circumstances'; it is only an action 'at law to determine the fair value of the dissenters' shares';[153]
>
> The Weinberger court was clear that the narrow remedy provided by an appraisal action does not encompass claims of fraud, self-dealing or breach of fiduciary duty; those claims are separate and distinct and can be redressed outside the appraisal remedy.[154]

On the contrary, the remedy of oppression is purported to assist the aggrieved shareholders. Whether the court, when valuing the shares, will consider the difference is still unknown.

3.2.3.4.3 The enhanced fiduciary duties owed by the controlling shareholder directly to other shareholders: the common law remedy

Development of the enhanced fiduciary duty

It has been generally recognized in the United States that directors, as well as officers and majority shareholders who participate in the management of the corporation, owe fiduciary duties to the corporation (the shareholders collectively) rather than to individual shareholders. In addition, shareholders normally do not owe fiduciary duties to other shareholders.[155] However, this attitude has changed to some extent over the last decades. Recognizing the unique nature of close corporations and their resemblance to partnerships, some courts have held that partnership-type duties should be imposed on the shareholders and directors of close corporations: they should owe heightened fiduciary duties to other shareholders.

One of the first cases imposing such duties was *Donahue v. Rodd Electrotype Co. of New England, Inc.*[156] In this case, the Massachusetts Supreme Judicial Court clarified the reasons for imposing such duties and illustrated the standard for such duties. It held that:

> Because of the fundamental resemblance of the close corporation to the partnership, the trust and confidence which are essential to this scale and manner of enterprise, and the inherent danger to minority interests in the close corporation, we hold that stockholders in the close corporation owe one

153 568 NW2d 794, 802, (Iowa 1997).

154 568 NW2d 794, 802 (Iowa 1997).

155 Hamilton (2000), p. 373; O'Neal & Thompson (2004), Section 9:19, 'Traditional Use of Fiduciary Duty', text accompanying Footnotes 1 and 2.

156 367 Mass. 578, 328 N.E.2d 505, (Massachusetts 1975).

> another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another. In our previous decisions, we have defined the standard of duty owed by partners to one another as the 'utmost good faith and loyalty.' Stockholders in close corporations must discharge their management and stockholder responsibilities in conformity with this strict good faith standard. They may not act out of avarice, expediency or self-interest in derogation of their duty of loyalty to the other stockholders and to the corporation.
> We contrast this strict good faith standard with the somewhat less stringent standard of fiduciary duty to which directors and stockholders of all corporations must adhere in the discharge of their corporate responsibilities
> ...
> The more rigorous duty of partners and participants in a joint adventure, here extended to stockholders in a close corporation, was described by then Chief Judge Cardozo of the New York Court of Appeals in *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545 (1928): 'Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. ... Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior'.[157]

However, the *Donahue* decision, if strictly applied, 'will result in the imposition of limitations on legitimate action by the controlling group in a close corporation which will unduly hamper its effectiveness in managing the corporation in the best interests of all concerned'.[158] Therefore, in the subsequent case of *Wilkes v. Springside Nursing Home, Inc.*[159], the Massachusetts Supreme Judicial Court developed the *Donahue* decision and tried to strike a balance between minority protection and efficient corporate management. Recognizing that the majority shareholders 'have certain rights to what has been termed 'selfish ownership' in the corporation which should be balanced against the concept of their fiduciary obligation to the minority'[160], the court developed the standard of 'legitimate business purpose' to decide whether the majority shareholder in a close corporation breached their *Donohue* fiduciary duties. The court should ask 'whether the controlling group can demonstrate a legitimate business purpose for its action'.[161] If the answer is affirmative, however, the minority shareholders should still have the opportunity 'to demonstrate that the same legitimate objective could have been achieved through an alternative course of action less harmful to the

157 367 Mass. 578, 592-594, 328 N.E.2d 505, 515-516 (Massachusetts 1975).

158 *Wilkes v. Springside Nursing Home, Inc.*, 370 Mass. 842, 850, 353 N.E.2d 657, 663 (Massachusetts 1976).

159 370 Mass. 842, 353 N.E.2d 657 (Massachusetts 1976).

160 370 Mass. 842, 850-851, 353 N.E.2d 657, 663 (Massachusetts 1976).

161 370 Mass. 842, 851, 353 N.E.2d 657 663 (Massachusetts 1976).

minority's interest'.[162] The court 'must weigh the legitimate business purpose, if any, against the practicability of a less harmful alternative'.[163]

The *Donahue* principle of a heightened fiduciary duty owed by a shareholder to other shareholders and the *Wilke's* standard of judicial review have been adopted by the courts in several states, although they take different approaches towards the scope and meaning of these fiduciary duties.[164] Nevertheless, some courts have still refused to apply the *Donahue* principle, such as the Delaware Supreme Court in the case of *Nixon v. Blackwell*.[165] In that case, the Delaware Supreme Court held that it should 'be a matter for legislative determination in Delaware' for duties to be created in a normal corporate practice such as the creation of employee stock ownership plans (ESOPs); it was inappropriate to create special judicial duties since that 'would border on judicial legislation'.[166] The court also held that '[i]t would do violence to normal corporate practice and our corporation law to fashion an *ad hoc* ruling which would result in a court-imposed stockholder buyout for which the parties had not contracted'.[167]

Some statutes have also recognized that heightened fiduciary duties exist among shareholders.[168] When deciding whether to grant relief under involuntary dissolution, the courts have been asked by some statutes to 'take into account the duty which all shareholders in a closely held corporation owe one another to act in an honest, fair, and reasonable manner in the operation of the corporation and the reasonable expectations of the shareholders ...'.[169] This also shows the relationship between the principle of fiduciary duties and the statutory involuntary dissolution remedy.[170]

Examples of the breach of heightened fiduciary duties

A majority shareholder's breach of the heightened fiduciary duties owed to other shareholders may include *non pro rata* distribution of profits to majority shareholders in which the minority shareholders were not permitted to share[171],

162 370 Mass. 842, 851-852, 353 N.E.2d 657, 663 (Massachusetts 1976).
163 370 Mass. 842, 852, 353 N.E.2d 657 663 (Massachusetts 1976).
164 Such as New York, Rhode Island, Illinois, Colorado, Mississippi, Minnesota, and Ohio; see Thompson (1993), p. 729; O'Neal & Thompson (2004), Section 9:21, 'Enhanced Fiduciary Duties,' Footnote 8.
165 626 A.2d 1366 (Delaware 1993).
166 626 A.2d 1366, 1377 (Delaware 1993).
167 626 A.2d 1366, 1380 (Delaware 1993).
168 Such as Minn. Stat. Ann. § 302A.751(3)(a) (Westlaw: M.S.A. s 302A.751(3)(a)); N.D. Cent. Code § 10-19.1-115(3) (Westlaw: ND ST 10-19.-115). Also see Thompson (1993), p. 729.
169 See Minn. Stat. Ann. § 302A.751(3)(a) (Westlaw: M.S.A. s 302A.751(3)(a)).
170 Thompson (1993), p. 729.
171 Such as *Donahue v. Rodd Electrotype Co. of New England, Inc.*, 367 Mass. 578, 328 N.E.2d 505, (Massachusetts 1975).

dismissal of the minority shareholder as a corporate officer and director[172], exclusion of the minority shareholder from significant participation[173], selling corporate assets to the majority shareholder or related parties for inadequate consideration[174], and causing the corporation not to pay bills owed to the minority's firm which later failed.[175] Therefore, by misconduct toward the corporation, the majority shareholder in a close corporation may also breach his duties owed to the minority shareholders, as well as his duties to the corporation. In fact, it is not always easy to distinguish whether the plaintiff should bring a direct or derivative action in such cases. For details about the distinction, please see Section 3.3.

Remedies

The aggrieved minority shareholder may acquire equitable remedies if he has successfully established that the defendant majority breached the heightened fiduciary duties owed to him. The court will exercise 'its traditional equity powers' to put him 'as nearly as possible in the same position which he would have occupied if there had been no wrongdoing ...'.[176] Forms of relief may include, for example, a preliminary injunction, a rescission of the unfair dealing, an order to give the plaintiff an equal opportunity, an order to distribute dividends, a realignment of shareholders ownership, as well as monetary relief such as damages or restitution.[177]

As mentioned, by injuring the corporation, the majority may have breached both its duties owed to the corporation and the duties owed to the minority shareholders. Therefore the problem is, as in the statutory oppression remedy, whether the plaintiff shareholder can claim for the reflective losses in such cases through a direct action which is based on the breach of the duties owed to him. Some courts have answered the question positively. In *Sugarman v. Sugarman*[178], the majority shareholder paid his father and himself excessive compensation and benefits, which were not available to the plaintiff shareholders, and offered to buy the plaintiffs' stocks for a grossly inadequate price. The Court of Appeals for the First Circuit held that these facts proved that the majority shareholder tried to improperly freeze the plaintiffs out of the company and therefore had breached

172 Such as *Wilkes v. Springside Nursing Home, Inc.*, 370 Mass. 842, 353 N.E.2d 657 (Massachusetts 1976).

173 *Orchard v. Covelli*, 590 F. Supp. 1548 (W.D. Pa. 1984), aff'd, 802 F.2d 448 (3d Cir. 1986); also see Thompson (1993), p. 728.

174 Such as *Dowling v. Narragansett Capital Corp.*, 735 F. Supp. 1105 (D.R.I. 1990).

175 Such as *Zimmerman v. Bogoff*, 524 N.E.2d 849, 402 Mass. 650, (Massachusetts 1988); also see Thompson (1993), p. 728.

176 *Zimmerman v. Bogoff*, 524 N.E.2d 849, 402 Mass. 650, 661 (1988) (quoting *Shulkin v. Shulkin*, 301 Mass. 184, 192-93 (1938)).

177 Billings (1996), pp. 5-14.

178 797 F.2d 3 (1st Cir. 1986).

his fiduciary duty to the minority shareholders. Instead of awarding damages to the corporation, the court awarded the damages directly to the plaintiffs in an amount equivalent to the amount of stock owned by them.[179] However, it has been argued that *Sugarman v. Sugarman* is uncommon. Billings regarded that *Sugarman v. Sugarman* was 'an unusual, even aberrant, example of overcompensation being redressed in a direct action; more commonly, the Massachusetts courts have required a derivative claim, reasoning that the injury is to the corporation and rejecting attempts to characterize overcompensation as part of a freeze-out scheme directed at the plaintiff'.[180]

In *Donahue v. Draper*[181], where the defendant shareholder had breached the agreement among the shareholders by appropriating the corporate goodwill upon the dissolution of the corporation, the court also awarded the plaintiff half of the value appropriated. Nevertheless, the case is regarded as being easier to explain than *Sugarman* since there was breach of agreement in this case.[182]

3.2.4 Ongoing debates as to the role of derivative action in the United States

We have just enumerated the features of the role of derivative action in the United States and have noted that such a role has been weakened in practice. However, neither theoretically nor judicially is it a settled issue as to the role the derivative action should play. In fact, there still are ongoing debates on this issue.

3.2.4.1 Compensation versus deterrence

3.2.4.1.1 The possible conflict between the functions of compensation and deterrence

As mentioned in Section 1.2.1, derivative actions have several functions, the most important of which are compensation and deterrence. We should pay special attention here to the fact that, although only the injured corporation will be directly compensated by a derivative action, the compensatory function, as studied by the American literature as well as judicial opinions, sometimes refers to direct compensation to the injured corporation, while at other times to indirect compensation to the shareholders in the corporation.

Generally the functions of compensation and deterrence do not conflict with each other because by compensating the injured party the derivative action also deters the wrongdoers and other persons from committing misconduct again. Never-

179 797 F.2d 3, 7-9 (1st Cir. 1986).
180 Billings (1996), p. 9.
181 22 Mass. App. Ct. 30 (1986).
182 Billings (1996), p. 9.

theless, in certain situations there are conflicts between the functions, such as in cases where the misconduct did not cause any damage to the corporation. In such a case, whether a derivative action will be allowed against the misconduct depends on the attitude towards the functions of the derivative action. If compensation is regarded as the prevailing purpose, then a derivative action will only be allowed when the corporation has suffered losses. However, if the deterrent function prevails, a derivative action will be allowed as long as there is misconduct, no matter whether the corporation suffered losses or not. Put simply, 'deterrence justifies a relaxation of standing criteria'.[183]

The conflict between compensation and deterrence generates practical problems in derivative actions. For example:

> Should a court dismiss an otherwise meritorious derivative action if it appears that costs of litigation will exceed the likely recovery? Should a defendant be permitted to raise the defense that the crime paid, that the benefits of illegal action undertaken by him on behalf of the corporation exceeded the costs and penalties imposed on the corporation as a result? Should a shareholder not injured by the misconduct be denied the ability to bring a meritorious derivative action that otherwise would not be pursued?[184]
> In each of these cases, a deterrent perspective tends to answer in the negative, while a compensatory rationale tends to respond in the affirmative.[185]

Therefore, the attitude towards the conflicting functions will directly affect the attitude towards the derivative action.

The attitude towards the functions of compensation and deterrence may affect the attitude towards derivative actions in another way. If the function of compensation is regarded as the prevailing purpose, the unsuccessful performance of the function may lead to the conclusion that derivative action is not satisfactory and that it then should not play an important role. In contrast, if the focus is on deterrence, the effect of compensation will not determine the effect of derivative actions; derivative actions may still play an important role even if there is hardly any compensatory function. I will discuss this issue further in Section 3.2.4.2.

3.2.4.1.2 Current judicial approaches

3.2.4.1.2.1 The judicial approach that compensation prevails over deterrence

The judicial approaches towards the conflicting functions of compensation and deterrence are not concurrent in the United States. The prevailing judicial approach is that compensation is the primary purpose while deterrence is simply

183 Cox (1984), p. 778.
184 Coffee & Schwartz (1981), p. 308.
185 Coffee & Schwartz (1981), p. 308.

the by-product[186], or in other words, the function of compensation prevails over deterrence. Two rules illustrate this approach.[187] The first rule is the 'net loss' requirement. Under this rule, the plaintiff shareholder in a derivative action must establish that the corporation has suffered a net loss through the misconduct, that is, the damage suffered by the corporation from the misconduct must exceed the benefit it acquired from the misconduct; otherwise, the action will be dismissed.[188]

The second rule, the 'vicarious incapacity' principle, goes even further. Under this principle, even if it suffered loss, the injured corporation is prevented from suing its former controlling shareholder if the current controlling shareholder acquired his shares from the defendant without loss.[189] The principle was first established in *Home Fire Insurance Co. v. Barber*.[190] In that case the defendants, who were also former shareholders, injured the corporation through mismanagement; later they transferred the shares to the current sole shareholder at a fair price. The Supreme Court of Nebraska denied the corporation's right to claim against the mismanagement since the current shareholder suffered no losses. Commissioner Pound held that:

> Where a corporation is not asserting or endeavoring to protect a title to property, it can only maintain a suit in equity as the representative of its stockholders.[191]
> … where it is proceeding in equity to assert rights of an equitable nature, or is seeking relief upon rules or principles of equity, the court of equity will not forget that the stockholders are the real and substantial beneficiaries of a recovery, and if the stockholders have no standing in equity, and are not equitably entitled to the remedy sought to be enforced by the corporation in their behalf and for their advantage, the corporation will not be permitted to recover.[192]

Rejecting that deterrence could justify the corporation's action, Commissioner Pound also held that 'If a wrongdoer deserves to be punished, it does not follow that others are to be enriched at his expense by a court of equity. A plaintiff must recover on the strength of his own case, not on the weakness of the defendant's case'.[193] The approach in *Home Fire Insurance Co. v. Barber* was accepted by the Supreme Court in *Bangor Punta Operations, Inc. v. Bangor & Aroostock Railroad*.[194] In this case, a majority shareholder, who acquired 98.3 percent of the

186 See Cox (1984), p. 764; Cox (1999), pp. 8-9.
187 Cox (1999), p. 8.
188 Cox (1999), pp. 8-9; Cox (1984), pp. 764-765; Forte (1965), pp. 333-339; Note (1964), p. 179.
189 Cox (1999), pp. 9-10; Cox (1984), pp. 765-766.
190 67 Neb. 644, 93 N.W. 1024 (1903).
191 67 Neb. 644, 93 N.W. 1024, 1031-1032 (1903).
192 67 Neb. 644, 93 N.W. 1024, 1033 (1903).
193 67 Neb. 644, 673, 93 N.W. 1024, 1035 (1903).
194 417 U.S. 703 (1974).

shares from a former controlling shareholder at a fair price, caused the corporation to sue the former shareholder and its parent corporation for an alleged misappropriation during their years of control. The case was accepted by the Court of Appeal for the First Circuit[195] but dismissed by the Supreme Court. The reason given by the Supreme Court was that if the case were allowed, most recovery to the corporation would go to this controlling shareholder, who knew about the alleged misconduct at the time of purchasing the shares and had suffered no loss from the misconduct. Therefore a recovery, if allowed, would be a windfall for him.[196] Here the Supreme Court's opinion is that deterrence alone cannot justify a corporate action; other considerations such as unjust enrichment may be more important factors.

The rationale under the 'vicarious incapacity' principle, stating that the prevention of unjust enrichment prevails over deterrence, also applies to derivative actions. The most obvious example is the contemporaneous ownership principle, which requires that the plaintiff shareholder own the shares at the time of the complaint of misconduct.[197] One purpose of the principle is 'to prevent unjust enrichment by those who acquired their shares with knowledge of the alleged wrong'.[198]

3.2.4.1.2.2 The judicial approach that deterrence predominates when the compensation function is absent

In the United States there is also another line of cases which recognizes the importance of the deterrent role and takes the approach that deterrence predominates when a compensatory function is absent. A typical statement of this approach can be found in the New York Court of Appeal's case of *Diamond v. Oreamuno*:

> It is true that the complaint before us does not contain any allegation of damages to the corporation but this has never been considered to be an essential requirement for a cause of action founded on a breach of fiduciary duty .... This is because the function of such an action, unlike an ordinary tort or contract case, is not merely to compensate the plaintiffs for wrongs committed by the defendant but, as this court declared many years ago ... 'to prevent them, by removing from agents and trustees all inducement to attempt dealing for their own benefit in matters which they have undertaken for their

195 *Bangor & Aroostook R.R. v. Bangor Punta Operations, Inc.*, 482 F.2d 865, 868 (1st Cir. 1973), rev'd, 417 U.S. 703 (1974).

196 *Bangor Punta*, 417 U.S. 703, 716-717 (1974).

197 Cox (1999), pp. 9-10. For a more detailed discussion of this principle, please refer to Section 3.4.2.1.

198 ALI (II), Section 7.02, p. 37. Other purposes include discouraging strike suits, preventing the purchase of suits and preventing the collusive establishment of a federal diversity jurisdiction. See Hamilton (2000), pp. 543-544; ALI (II), Section 7.02, p. 37; Cox (1984), p. 767.

own benefit in matters which they have undertaken for others, or to which their agency or trust relates'.[199]

Other cases reflecting the same approach include the Supreme Court cases of *Mills v. Electric Auto-Lite Co.*[200] and *City of Riverside v. Rivera*[201], and the Delaware Supreme Court cases of *Zapata Corp. v. Maldonado*.[202]

3.2.4.1.2.3 The third approach which considers neither compensation nor deterrence to be the major concern

There is also a third approach which considers that both compensation and deterrence are superseded by other considerations, such as the shareholders' responsibility for supervising management or management's motivation of risk-taking. If a derivative action is regarded as adversely affecting these concerns, the court may disallow the derivative action.[203] Nevertheless, this is not a common approach, and I will not discuss it further.

3.2.4.1.2.4 Comments

3.2.4.1.2.4.1 Problems of the first approach

The first approach has been much criticized, especially by academics. For example, Cox held that 'The most apparent error courts make is elevating compensation over deterrence in defining the mission of the derivative suit'.[204] Coffee and Schwartz submitted that 'Such a rationale may have been appropriate when the derivative action first emerged, but today the changed relationship between the shareholder and his corporation makes such a rationale seem increasingly anachronistic'.[205]

Generally, criticisms of the first approach are as follows. First, 'compensation is a goal that the derivative action can realize only imperfectly'.[206] This may be due to several reasons: the constant transfer of shares especially in public corporations may cause some shareholders to go uncompensated while some get windfalls; the injury to the corporation and the injury to the individual shareholder is unlikely to be congruent; and the recovery is normally rather small both for the cor-

199 24 N.Y.2d 494, 498 (N.Y. 1969).
200 396 U.S. 375, 90 S.Ct. 616, 24 L.Ed.2d 593 (1970).
201 477 U.S. 561, 106 S.Ct. 2686, 91 L.Ed.2d 466 (1986).
202 430 A.2d 779, 789, (Delaware 1981). Also see ALI(II), Part VII, chapter 1, Introductory Note, Reporter's Note, pp.12-13.
203 *Cenco Inc. v. Seidman & Seidman*, 686 F.2d 449 (7th Cir.), cert. denied, 459 U.S. 880 (1982); Cox (1984), pp. 755-758.
204 Cox (1999), p. 39.
205 Coffee & Schwartz (1981), p. 302.
206 Coffee & Schwartz (1981), p. 302.

poration (considering its whole value of assets) and for the individual shareholder (due to the small percentage of his shares).[207] In addition, in some cases the relief may not be of a financial nature.[208] Second, the first approach ignores the social value of derivative actions. Derivative actions are generally against breaches of fiduciary duties, something that has substantial public influence.[209] If derivative actions are intended to police corporate management and improve corporate governance generally, their deterrent role should be improved. 'Compensating the injured is a private matter, whereas deterrence is of public concern'.[210] Third, the 'net loss' requirement rule based on this approach ignores the long-term interests of the company. In certain cases, although there is no 'net loss' caused by the alleged misconduct, the company will suffer long-term damage because the wrongdoer has not been punished and bad corporate management may continue. In fact, how to define 'loss' is a tricky issue. Fourth, if the 'contemporaneous ownership' requirement based on this approach is justified by the necessity for preventing unjust enrichment, it may conflict with the nature of derivative action. Since damages under derivative actions will be awarded to the injured corporation, preventing shareholders who bought their shares after the misconduct from bringing a derivative action may cause the corporation and other stakeholders to remain uncompensated.[211] In addition, if a shareholder who satisfies the contemporaneous ownership requirement brings a derivative action, the non-qualified shareholder may still reap a proportional gain indirectly because the damages will be awarded to the corporation.

3.2.4.1.2.4.2 Problems of the second approach

Application of the second approach without any limitation may also create the problem of over-deterrence and a possible abuse of derivative actions. Since the second approach justifies a relaxation of the standing requirement on initiating derivative actions, it will be easier for minority shareholders to bring vexatious suits. In addition, the effect of the deterrence function also depends on public esteem for the derivative action. If the derivative action was notorious for the abuse of its use and the low possibility of it benefiting the corporation and its shareholders, there would hardly be any deterrent effect.

3.2.4.1.2.4.3 Striking a balance between the two approaches

On the one hand, due to problems resulting from the predominance of the compensatory function, many researchers have suggested an improved deterrent function. For example, Cox suggests that courts should consider the deterrent

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207 Coffee & Schwartz (1981), pp. 302-305; Cox (1999), p. 16.

208 Cox (1999), p. 16.

209 Cox (1999), p. 11.

210 Cox (1999), p. 11.

211 The reform of the Pennsylvanian law on the 'contemporaneous ownership' requirement shows that this criticism has been accepted in Pennsylvania; for the Pennsylvanian law, see Section 3.4.2.1.

function when granting standing to initiate derivative suits and approving settlement, so that 'the public character of the norms raised by the suit' can be emphasized.[212] Coffee and Schwartz also point out that 'the derivative action is in some ways naturally adapted to a deterrent rationale, principally because it harnesses private enforcement resources and focuses its penalties on the individual rather than the corporation'.[213] On the other hand, due to the concern about overdeterrence, how far the deterrent function should go in derivative actions still remains problematic. Nevertheless, it is generally accepted that there should not be an absolute application of either approach; a balance should be struck between the two approaches.[214]

The ALI Principles also propose a balance between compensation and deterrence. On the one hand, if the deterrent function is regarded as an important and independent purpose of derivative actions rather than a mere consequence of the compensatory function, the derivative action can protect the long-term interests of the corporation by punishing the misconduct.[215] The general deterrent function may also improve corporate management and thus reduce general agency costs.[216] The shareholders in the harmed corporation may also benefit from the general deterrent function if they hold a portfolio of securities.[217] On the other hand, however, the ALI 'is particularly sensitive to the danger of overdeterrence and the impact of even the potential risk of litigation on the willingness of outside directors to serve and on their conduct as directors'.[218] There are some examples of the ALI's efforts to strike a balance between compensation and deterrence. The first example is that found in Section 7.10(b) of the ALI Principles where the ALI recognizes that:

> ... under certain limited circumstances the long-run deterrent value of the derivative action and the social and economic importance of confidence in the integrity of the corporate system generally outweigh the corporation's interest in a swift termination procedure for actions that seem unlikely to produce a net monetary benefit for it.[219]

Another example is that the ALI has also adopted a relaxed contemporaneous ownership rule in Section 7.02. According to Section 7.02(a)(1) of the ALI Principles, a shareholder, who acquired the shares before the alleged wrong was

212 Cox (1999), p. 39.
213 Coffee & Schwartz (1981), p. 305.
214 See, for example, Coffee & Schwartz (1981), pp. 308-309.
215 ALI (II), Part VII, Chapter 1, Introductory Note, p. 8.
216 ALI (II), Part VII, Chapter 1, Introductory Note, Reporter's Note, p. 16.
217 ALI (II), Part VII, Chapter 1, Introductory Note, Reporter's Note, p. 16.
218 ALI (II), Part VII, Chapter 1, Introductory Note, p. 8.
219 ALI (II), Section 7.10, Comment G, p. 148.

publicly disclosed or was known by him, can commence and maintain a derivative action even if he was not a shareholder when the alleged wrong was committed. However, this relaxation is more concerned with avoiding unjust enrichment than improving the deterrent function of derivative actions.[220] As long as the contemporaneous ownership principle is retained, the purpose of the derivative action is still compensation oriented.[221] A more radical reform has been taken in Pennsylvania. Under Pennsylvanian law, a shareholder can bring a derivative action when it is necessary to avoid the injustice of a serious wrong to the corporation going unredressed.[222]

3.2.4.2 Debates as to the role of derivative action

3.2.4.2.1 Doubts about the prominent role of derivative action

Originally the prevailing approach of the derivative action was that it was 'the chief regulator of corporate management'.[223] However, the prominent role of the derivative action was brought into doubt later due to problems resulting from derivative actions, such as the ineffectiveness of the suits (the corporations and the shareholders were barely ever compensated by the suits)[224], the high rate of settlements, the high litigation costs of the suits, and the fact that many cases were driven by the plaintiff's attorneys and that many cases were strike suits. These problems have been detected by several empirical studies, such as the Wood Report.[225] Although these studies have been carried out from different perspectives and are based on different samples, they share skepticism about the effect of derivative actions and come to the conclusion that 'there is a greater likelihood that more of these suits are frivolous'[226] and that 'derivative suits are not an important monitoring device to curb managerial malfeasance'.[227] By examining the market reaction to judicial decisions as to whether to allow or terminate a derivative action, Fischel and Bradley used econometric techniques to study the effect of a derivative action on the wealth of a company's shareholders.[228] The study showed that 'a successful derivative suit, on average, has a slight positive effect on the wealth of the firm's stockholders' and 'a court's

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220 Cox (1999), p. 39.

221 Cox (1999), p. 39.

222 See 15 Pa. Bus. Corp. Law § 1782(b) (Westlaw: 15 Pa.C.S.A s 1782(b) (Pennsylvania Statutes and Consolidated Statutes Annotated)).

223 *Cohen v. Beneficial Industrial Loan Corp*, 337 U.S. 541, 548, 69 S.Ct. 1221, 1226 (1949).

224 Romano (1991), p. 61.

225 See Section 3.1.1.3. Other empirical surveys include, for example, Jones (1980a), Jones (1980b), Fischel & Bradley (1986), and Romano (1991); see ALI (II), Part VII, Chapter 1, Introductory Note, Reporter's Note.

226 Romano (1991), p. 61.

227 Fischel & Bradley (1986), p. 282.

228 Fischel & Bradley (1986), p. 278.

termination of such a suit has a slight negative effect on shareholder wealth'.[229] Thus they concluded that 'derivative suits are not an important monitoring device to curb managerial malfeasance' because '[i]f derivative suits were effective monitors we would expect a much greater market reaction to the court decisions in this study'.[230] Professor Romano's research is more recent. She randomly selected 535 public companies over a period extending from the late 1960s to 1987 for her study. The study showed that the rate of settlement in derivative actions was high[231] and that the amount of recovery to the companies was small[232], while most cases involved fees awarded to the plaintiff's attorneys. Professor Romano also examined stock price reactions to announcements of the commencement and termination of shareholder litigations (both class actions and derivative actions) and drew the conclusion, similar to Fischel and Bradle's, that the changes in stock price 'do not provide compelling support for the proposition that shareholders experience significant wealth effects from litigations'.[233] As a result, both of these studies conclude that derivative action yielded no significant wealth effect. The compensatory role of derivative action was thus in doubt.

American legislatures and courts also seem to take the approach that the function of derivative actions is a doubtful one. As a result, more restrictions have been placed on derivative actions. The ALI, although it does not wholly agree with the empirical studies and considers it difficult to make an overall evaluation of the derivative action, does regard the derivative action as 'neither the initial nor the primary protection for shareholders against managerial misconduct'.[234]

3.2.4.2.2 The approach favoring a strengthened role for derivative action

Nevertheless, the derivative action still has its proponents, who suggest a strengthened role for the derivative action. Some arguments are based on the deterrent or educational functions of the derivative action. They regard the derivative action as something that cannot be judged simply by its compensatory function, which 'most certainly will condemn it to failure'.[235] Instead, the value of the derivative action should be judged by its other functions as well, such as its deterrent and educational functions:

229 Fischel & Bradley (1986), p. 282.

230 Fischel & Bradley (1986), p. 282. However, the ALI doubts the reliability of the data in this study; see Section 3.2.4.2.2.

231 Eighty-three out of one hundred twenty-eight actions (about 65%) were settled; see Romano (1991), p. 60.

232 The average recovery in derivative actions was about half of that awarded in class actions, see Romano (1991), p. 61.

233 Romano (1991), at pp. 65-66.

234 ALI (II), Part VII, Chapter 1, Introductory Note, p. 5.

235 Cox (1999), p. 16.

> Despite the numerous abuses which have developed in connection with such suits they have accomplished much in policing the corporate system especially in protecting corporate ownership as against corporate management. They have educated corporate directors in the principles of fiduciary responsibility and undivided loyalty. They have encouraged faith in the wisdom of full disclosure to stockholders. They have discouraged membership on boards by persons not truly interested in the corporation ... The measure of effectiveness of the stockholder's derivative suit cannot be taken by a computation of the money recovery in the litigated cases. The minatory effect of such actions has undoubtedly prevented diversion of large amounts from stockholders to management and outsiders.[236]

Other proponents of derivative actions doubt the seriousness of the problems with them and even deny that problems exist, especially those problems with strike suits and the ineffectiveness of derivative actions in general. For example, Macey and Miller suggest that 'strike suit litigation is relatively uncommon'.[237] They point out that defendants, as repeat players in shareholders' litigations, are unlikely to settle suits because that would make them easy targets and generate more frivolous suits; plaintiffs' attorneys are unlikely to bring strike suits either, due to the substantial risks inherent in these suits.[238] Coffee also points out that the high rate of settlement does not necessarily suggest that most cases are cases without merit and that the low incidence of litigated plaintiffs' victories does not mean that the plaintiffs abuse the suits. It is more probable that the low rate of plaintiffs' victories reflects the asymmetric stakes in derivative actions: in derivative actions what the defendants lose is much more than what the plaintiffs or their attorneys receive and, therefore, the defendants are likely to litigate cases which they have a greater chance of winning, while by the same token settling other cases.[239]

It is also submitted that the plaintiffs' attorneys should not be blamed for the problems of derivative actions:

> The mere fact that lawyers pursue their own economic interest in bringing derivative litigation cannot be held as grounds to disqualify a derivative plaintiff ... To be sure, a real possibility exists that the economic motives of attorneys may influence the remedy sought or the conduct of the litigation. This influence, however, is inherent in private enforcement mechanisms and does not necessarily vitiate the substantial beneficial impact upon the conduct of fiduciaries.[240]

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236 *Brendle v. Smith*, 46 F. Supp. 522, 525-526 (S.D.N.Y. 1942).
237 Macey & Miller (1991), p.78.
238 Macey & Miller (1991), p.78.
239 Coffee (1986), pp. 700-701.
240 *In re Fuqua Industries, Inc.*, 752 A.2d 126, 133 (Del. Ch. 1999).

The empirical studies that confirm the problems of derivative actions, as mentioned above, have also been brought into doubt. For example, re-analyses of Wood's data have shown that the overall rate of plaintiff's success (cases where some recovery was granted) was about forty-four percent and 'compared favorably with the rate of plaintiff's success in similar forms of civil litigation'.[241] Fischel and Bradley's survey, which examined the change in the market price of the common stock of firms involved in derivative actions[242], was also criticized.[243] The ALI gave several reasons for its doubts about the survey.[244] First, the data might not be reliable due to the methodology the study used. The study questionably presumed that stock markets would sensibly react to the relatively small recoveries from derivative actions. In addition, there is no evidence that the market's expectation was frustrated by the termination of any derivative actions. Second, even if the data were reliable, the indifference of the market price to derivative actions should not necessarily result in the conclusion that these derivative actions were ineffective. The indifference may be due to concern over collusive or cosmetic settlements, which leave nothing to the corporation. Moreover, the deterrent effect of derivative actions generally will not be reflected in the price of stocks in one single corporation.

Very recent empirical research has also come up with a result contradicting the previous ones. By studying all corporate law complaints filed in Delaware over a two-year period from 1999 to 2000, Thompson and Thomas found:

> ... that there are a small number of derivative suits, about thirty per year, brought against public companies incorporated in Delaware. Contrary to earlier studies, we do not find evidence that that these cases are 'strike suits' yielding little benefit. Instead, roughly 30 percent of the derivative suits provide relief to the corporation or the shareholders, while the others are usually dismissed quickly with little apparent litigation activity. In cases producing a recovery to shareholders, the amount of recovery typically exceeds the amount of attorneys' fees awarded by a significant margin. The cases do demonstrate some indicia of litigation agency costs (for example, suits being filed quickly, multiple suits per controversy, and repeat plaintiffs' law firms), but each of these costs is much less pronounced for derivative suits than for other forms of representative litigation. Overall, the claim that derivative suits are typically strike suits is much weaker than in earlier periods.[245]

241 ALI (II), Part VII, Chapter 1, Introductory Note, Reporter's Note, p. 9.

242 Fischel & Bradley (1986), pp. 277-283.

243 ALI (II), Part VII, Chapter 1, Introductory Note, Reporter's Note, p. 12. For the comments on the study, also see Ribstein (1986).

244 ALI (II), Part VII, Chapter 1, Introductory Note, Reporter's Note, p.12.

245 Thompson & Thomas (2004), pp. 1749-1750.

Different methods have also been suggested for strengthening the role of derivative actions. For example, Buxbaum, Coffee and Schwartz have suggested that the board's powers to terminate derivative actions should be decreased[246]; Scott, distinguishing the duty of loyalty from the duty of care, suggests removing obstacles to derivative actions that enforce the duty of loyalty[247]; and Thompson and Thomas suggest that derivative actions against public corporations brought by investors holding one percent or more of the corporate shares should be excused from the demand requirement that is currently applied.[248]

3.3 The proper plaintiff principle: the distinction between derivative action and direct action

3.3.1 Criteria applied in American law generally

In determining whether an action should be direct or derivative, American courts are not bound by the label applied by the plaintiff in the pleading, instead they will look to the body of the complaint and apply certain criteria to decide the nature of the action.[249] The major criteria employed are the injury and the right criteria, nevertheless, some courts may also consider other factors. Therefore, as will be seen, the distinction is not always consistent in case law.

We should also bear in mind that the difficulty for the plaintiff in clarifying the nature of the action may always be alleviated by claiming both of the actions alternatively or concurrently.[250]

3.3.1.1 The injury and the right criteria

3.3.1.1.1 Introduction to the injury and the right criteria

The most common criterion employed by American courts to distinguish derivative actions from direct actions is the injury criterion and/or the right criterion. Many statements such as the following can be found in the American literature and cases:

> In determining whether a particular claim is derivative or personal, the Court must consider the nature of the harm inflicted and the nature of the rights violated. Where the injury is personalized to a shareholder and flows from a violation of rights inherent in the ownership of stock, suit may be brought by

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246 Buxbaum (1980); Coffee & Schwartz (1981).

247 Scott (1983).

248 Thompson & Thomas (2004), pp. 1749-1750.

249 *Rubinstein v. Skyteller, Inc.*, 48 F.Supp.2d 315, 323 (S.D.N.Y. 1999); Ferrara et al. (2005), Section 1.02, text accompanying Footnotes 13-18.

250 Billings (1996), p. 12.

the shareholders. On the other hand, where the injury is to the corporation and only affects the shareholders incidentally, the action is derivative.[251]

Here, an injury suffered by the shareholder personally does not require that the injury thus suffered be separate and distinct from that suffered by other shareholders.[252] In fact, an injury may affect a substantial number of shareholders individually and still not be a corporate injury. In such cases, direct actions may still be allowed in the form of class actions.

Legal rights and injury relate to each other. Since it is legally defined, an injury is not cognizable if the victim has no right to sue directly for relief.[253] Actually, an injury presupposes certain legal rights: without a legal right, no cognizable injury exists.[254] Therefore, in most cases the employment of the injury and the right criteria leads to no substantial differences in the results. For example, violation of corporate legal rights leads to injury to the corporation, while violation of shareholder's individual rights directly leads to injury to the shareholder.

However, there may be some exceptions and the infringement of rights may not be identical to the injury suffered: sometimes the infringement of rights may lead to no injury; while sometimes a wrongful act may infringe both the rights of the corporation and of shareholders individually. In the latter case, the identification of the action may not only depend on the right infringed, but also on the plaintiff's complaints or the remedies sought by the plaintiff. A good example is the claims against *ultra vires* acts, which I will discuss in Section 3.3.2.1.

3.3.1.1.2 Non-exhaustive categories of actions based on the right and/or injury criteria

Shareholder's personal rights and direct actions

As mentioned, injuries presuppose legal rights. Therefore, we will first identify the shareholder's personal rights. Generally there are two groups of sources for the shareholder's personal rights: the first is the statutory law, the constitutions of the corporation, a shareholder agreement with the corporation, or an agreement among the shareholders, including implied contracts.[255] The second group of sources is the duties owed to the shareholder individually by the wrongdoer, such as the common law fiduciary duties owed to the shareholder, contracts or torts duties with respect to which the shareholder is a party in an individual capacity.[256]

251 *Dowling v. Narragansett Capital Corp.*, 735 F. Supp. 1105, 1113 (D.R.I. 1990).
252 Cox & Hazen (2002), pp. 421-422.
253 Welch (1994), p. 155.
254 Welch (1994), p. 155.
255 Welch (1994), p. 163.
256 Welch (1994), pp. 163-164.

Basically, a shareholder's personal rights include, *inter alia*: the right to dividends, the right to inspect corporate books and records, the right to vote, the right to attend the general meeting of shareholders, the right to have the constitutions followed, the claim 'that corporate officials sought to 'entrench' themselves or manipulate the corporate machinery so as to frustrate plaintiff's attempt to secure representation or obtain control,' the claim 'that proposed corporate action should be enjoined as *ultra vires*, fraudulent, or designed to harm a specific shareholder illegitimately,' the claim 'that minority shareholders have been oppressed or that corporate dissolution or similar equitable relief is justified,' the claim 'that a proposed corporate control transaction, recapitalization, redemption, or similar defensive transaction unfairly affects the plaintiff shareholder,' and so on.[257] Actions enforcing these rights are, therefore, direct actions normally. Specifically, the following actions are generally regarded as direct actions although there may be different approaches:

> (1) actions to enforce the right to vote, to protect preemptive rights, to prevent the improper dilution of voting rights, or to enjoin the improper voting of shares; (2) actions to compel dividends or to protect accrued dividend arrearages; (3) actions challenging the use of corporate machinery or the issuance of stock for a wrongful purpose (such as an attempt to perpetuate management in control or to frustrate voting power legitimately acquired by existing shareholders); (4) actions to enjoin an *ultra vires* or unauthorized act; (5) actions to prevent oppression of, or fraud against, minority shareholders; (6) actions to compel dissolution, appoint a receiver, or obtain similar equitable relief; (7) actions challenging the improper expulsion of shareolders through mergers, redemption, or other means; (8) actions to inspect corporate books and records; (9) actions to require the holding of a shareholders' meeting or the sending of notice thereof; and (10) actions to hold controlling shareholders liable for acts undertaken in their individual capacities that depress the value of the minority's shares.[258]

Derivative actions

Any damage to the corporation is regarded as directly done to the corporation rather than to the shareholders, even though the shareholders also suffer diminution in the value of their shares; such diminution is only regarded as shareholders' indirect losses. Therefore, a shareholder can only bring derivative actions against such a corporate injury. This principle was first established in *Smith v. Hurd*[259] and is widely accepted today.[260] This distinction is in fact based on the 'injury' criterion.

257 ALI (II), Section 7.01, Reporter's Note 1, pp. 26-28.
258 ALI (II), Section 7.01, Comment C, p. 18.
259 53 Mass. 371 (1847).
260 ALI (II), Section 7.01, Reporter's Note 2, p. 28; Note (1962), p. 1148.

Derivative actions can also be detected from the 'rights' criterion. For example, since directors, officers and the controlling shareholders are generally regarded as owing fiduciary duties 'to the corporation as a whole rather than to individual shareholders or to individual classes of shareholders'[261], an individual shareholder normally should bring derivative claims against the breach of such duties, such as 'claims of gross negligence, mismanagement, self-dealing, excessive compensation, and usurpation of corporate opportunity'.[262] Nevertheless, some of these claims may also lead to a shareholder's direct action in close corporations, which I will discuss later in Section 3.3.3.

Direct or derivative actions or both

The classifications of actions mentioned above are neither exhaustive nor unconditional. In fact, it is more difficult to draw a line between the injuries to or the rights of the corporation and the shareholder than it might seem. While in many cases the line is clear, it is also often hazy. This is especially the case where the same misconduct may give rise to either a direct or a derivative action or both. For example, there is a split of authority on identifying the plaintiff's claims for compelling dividends.[263] While it is generally agreed that claims for declared dividends are direct actions, there have been disagreements as to compelling dividends.[264] The claim may be direct and individual since '[t]he right to dividends is an incident of [stock] ownership'; here shareholders were injured directly due to the failure of distribution of dividends.[265] On the other hand, a derivative action was also allowed by holding that the duty owed by the directors was to the corporation.[266] Although nowadays a direct action is the prevailing view, a derivative action may still be justified on the grounds that the corporation also suffered losses due to 'punitive excess retained-earnings taxes or that the retained earnings will otherwise be used improvidently'.[267]

The difficulty of identifying actions occurs especially in certain situations such as *ultra vires* or unauthorized act, and breaches of duties by directors and controlling shareholders, which I will discuss in Section 3.3.2.

3.3.1.2 Other considerations

In addition to rights and/or injury criteria, the court may also take into account other factors, such as policy bases for derivative actions, the competing interests

261 Hamilton (2000), p. 445.

262 Thompson (1993), p. 732; O'Neal & Thompson (2004), Section 9.22 (Direct v. derivative suits; individual recovery in derivative suits).

263 Cox & Hazen (2002), p. 421.

264 Cox & Hazen (2002), p. 421.

265 *Knapp v. Bankers Sec. Corp.*, 230 F.2d 717 (3d Cir. 1956).

266 *Gordon v. Elliman*, 119 N.E.2d 331 (N.Y. 1954).

267 Cox & Hazen (2002), p. 421.

of each party[268], or even the results from the characterization[269] when identifying an action. Indeed, the court is regarded as having 'wide discretion in interpreting whether a complaint states a derivative or primary claim'.[270] Although these factors may be of secondary significance in the identification of action[271], they still deserve our attention.

Policy considerations

As mentioned, the policy justifications for derivative actions include, for example, the need to protect the creditors and other stakeholders of the corporation, the avoidance of multiplicity of law suits, the prevention of unjust interference in corporate management by individual shareholders, and the judicial policy of favoring the resolution of corporate disputes within the structure of the corporation.[272] When determining whether a suit should be derivative or not, the court may also consider whether such justifications for derivative suits exist. For example, where the plaintiff shareholder only seeks injunctive or prospective relief instead of damages, courts are more willing to permit direct actions because the policy considerations favoring derivative actions are less convincing: the relief sought does not involve financial recovery, but will benefit all shareholders proportionately as well as other stakeholders. In addition, there is no financial motivation on the part of the plaintiff shareholder and therefore there is less risk of abuse of the suit.[273] This approach actually explains why courts often allow a shareholder's direct action to enjoin mergers, recapitalizations and similar structural changes.[274]

Results of the action

Courts may also consider results such as the adequacy of remedies available under each action in order to determine the type of suit. In *Hanson v. Kake Tribal Corp.*[275], the plaintiff shareholders brought class actions against the village corporation for discriminatory payment of dividends based on a financial security plan which was adopted by the corporate directors to further the social and financial welfare of some shareholders. According to the plan only the original shareholders would receive the dividend. Although the illegal payments diminished the corporate assets and there were many shareholders who neither received the illegal payments through the plan nor were included as members of

268 Note (1962); ALI (II), Section 7.01, Comment D, p. 20; Welch (1994), pp. 165-166.
269 *Hanson v. Kake Tribal Corp.*, 939 P.2d 1320, (Alaska 1997).
270 *Hanson v. Kake Tribal Corp.*, 939 P.2d 1320, 1327 (Alaska 1997).
271 Welch (1994), p. 165.
272 See Section 1. Also see Welch (1994), pp. 165-166.
273 ALI (II), Section 7.01, Comment D, p. 20; ALI (II), Section 7.01, Reporter's Note 1, p. 28.
274 ALI (II), Section 7.01, Comment D, p. 20; ALI (II), Section 7.01, Reporter's Note 1, p. 28.
275 939 P.2d 1320, (Alaska, 1997).

the class of plaintiff shareholders, the Supreme Court of Alaska allowed the class action. The court considered that a derivative action was not appropriate since it would not adequately compensate the plaintiffs. In this case, the recipients of the misappropriated funds were shareholders who did not know the distribution was illegal when receiving the dividend, therefore, the corporation might not have been entitled to damages from such shareholders.[276] In addition, 'it is unlikely that any damages collected from the responsible directors and officers would approximate the sum of payments made under the plan'.[277] In fact, the Supreme Court of Alaska's classification of the action is regarded as representing 'a choice between imperfect alternatives, each carrying significant drawbacks'.[278]

3.3.1.3 Application of the criteria

It is common for the court to apply more than one criterion, at least to some extent, in determining the nature of the action.[279] Since the distinction between the shareholder's individual 'rights' and/or 'injury' and those of the corporation is not always easy, other criteria may be applied to identify the nature of the action. Nevertheless, the rights and/or the injury criteria are still basic and other considerations are only 'of secondary significance'.[280]

However, there is still another voice commenting on the application of the criteria. Welch considers that the application of various criteria is 'both confusing and time consuming'.[281] Regarding the rights criterion as the most compelling one, he suggests that there should be only one test, that is, the rights criterion, and 'no other criteria need be mentioned ... except optionally in order to elaborate on the consequences of the court's determination'.[282] The dissenting Judge Fabe in *Hanson v. Kake Tribal Corp.* also shared this approach. Judge Fabe disagreed with the majority's opinion that the classification of action would be judged by the adequacy of the recovery. Instead, he insisted the focus of the classification should be on the nature of the harm.[283]

3.3.2 Distinction in several situations

The distinction between direct and derivative actions is especially difficult in several situations to which I will pay special attention in the following sections.

276 939 P.2d 1320, 1326-1328 (Alaska, 1997).
277 939 P.2d 1320, 1327 (Alaska 1997).
278 DeMott (2003), Section 2:4, p. 2-30.
279 Welch (1994), p. 166.
280 Welch (1994), p. 165.
281 Welch (1994), pp. 166-167.
282 Welch (1994), p. 167.
283 *Hanson v. Kake Tribal Corp.*, 939 P.2d 1320, 1334 (Alaska 1997).

3.3.2.1 *Claims arising from ultra vires or unauthorized acts*

American law generally recognizes the dual consequences of *ultra vires* or unauthorized acts. On the one hand, if a company suffers losses from the *ultra vires* or unauthorized act, the claim for damages against the act belongs to the company and therefore a shareholder can only bring a derivative action to enforce the claim.[284] On the other hand, a shareholder can bring a direct action if he only claims injunction, that is, to enjoin the *ultra vires* or unauthorized act.[285]

The dual consequences of the *ultra vires* or unauthorized act are due to the twin aspects of the act. By causing damage to the corporation, the *ultra vires* or unauthorized act not only infringes on the rights of the corporation, but also infringes on the individual shareholder's right to 'have the corporate property managed in their interest'[286], even though the individual shareholder may suffer no direct financial losses. In such cases, the identification of action may not simply depend on the right and/or injury criteria, but also on the plaintiff's complaints, or in other words, the remedies sought by the plaintiff. This approach was clearly illustrated in *Crouse-Hinds Co. v. InterNorth, Inc.*:

> A shareholder's financial interest in a corporation provides two separate grounds for standing to challenge the actions of a board of directors depending upon the nature of the asserted claim. In one type of action, a shareholder sues the corporation solely in a personal capacity and complains that the acts of the corporation, its officers or third persons, have undermined the rights of the shareholders to exercise their relative voice in corporate affairs. [Citation omitted] The second type of shareholder suit is a derivative action which arises out of a 'primary right of a corporation but which is asserted on its behalf by the stockholder because of the corporation's failure, deliberate or otherwise, to act upon the primary right.' [Citation omitted] …
> In distinguishing between a personal and derivative action, a court is required to look to the plaintiff's complaint. [Citation omitted] It should be further noted that because the shareholders are possessed of a right to have the corporate property managed in their interest, any shareholder may bring an action to enjoin the misapplication of its assets, or to enjoin *ultra vires* acts.[287]

284 ALI (II), Section 7.01, Reporter's Note 1, F, p. 27; *Starbird v. Lane*, 203 Cal. App.2d 247, 21 Cal.Rptr. 280 (1962).

285 ALI (II), Section 7.01, Reporter's Note 1, F, p. 27.

286 *Crouse-Hinds Co. v. InterNorth, Inc.*, 518 F.Supp. 390, 402, (N.D.N.Y. 1980), rev'd on other grounds, 634 F.2d 690 (2d Cir. 1980).

287 *Crouse-Hinds Co. v. InterNorth, Inc.*, 518 F.Supp. 390, 402, (N.D.N.Y. 1980), rev'd on other grounds, 634 F.2d 690 (2d Cir. 1980).

3.3.2.2 *Claims arising from breach of duties by corporate fiduciaries*

The 'personal injury' doctrine (or the 'special duty' doctrine)

Directors, controlling shareholders and senior officers of a corporation normally have wide powers to control, manage and direct the corporation. Therefore they are generally regarded as owing fiduciary duties to the corporation.[288] These fiduciary duties are basically owed to the corporation rather than to individual shareholders.[289] Therefore, where the fiduciaries breached their duties and injured the corporation, normally a shareholder can only bring a derivative action against this breach.

However, there are also exceptions to this general rule. If due to the fiduciary's misconduct an individual shareholder has suffered a 'personal' injury that is separate and distinct from that suffered by the corporation, or if the misconduct has violated a special duty owed to the shareholder such as a contractual duty, a shareholder's direct action may be allowed even though the alleged wrong involved the corporate management, principally injured the corporation and involved a corporate action.[290] This is called the 'personal injury' doctrine or the 'special duty' doctrine.[291]

A 'special duty' may be found where the wrongdoing corporate fiduciaries occupy a dual relationship.[292] For example, they are directors, officers, or the controlling shareholders of the corporation and therefore owe fiduciary duties to the corporation. At the same time, they may have another relationship with an individual shareholder in such a way that guard, trust or pledge exists between them.[293] In fact, the 'special duty' exception originated from exactly such cases.[294]

The second circumstance of the exception is where there is a contract between the wrongdoing fiduciary and the individual shareholder, or where the individual shareholder is the beneficiary of a contract which the defendant, as a party, has breached.[295] The court sometimes has even gone so far as to permit a direct action where there was breach of contract, but where the misconduct related to the corporate management and where the plaintiff shareholder did not suffer an injury that was separate and distinct from that suffered by the corporation. In

288 Hamilton (2000), pp. 444-445.
289 Hamilton (2000), pp. 444-445.
290 ALI (II), Section 7.01, Comment C, p. 19; ALI (II), Section 7.01, Reporter's Note 3, p. 29; *Hikita v. Nichiro Gyogyo Kaisha, Ltd.*, 713 P.2d 1197, 1199 (Alaska 1986).
291 ALI (II), Section 7.01, Comment C, p.19; ALI (II), Section 7.01, Reporter's Note 3, p. 29.
292 ALI (II), Section 7.01, Reporter's Note 3, p. 29.
293 ALI (II), Section 7.01, Reporter's Note 3, p. 29.
294 ALI (II), Section 7.01, Reporter's Note 3, p. 29.
295 ALI (II), Section 7.01, Reporter's Note 3, p. 29.

Hikita v. Nichiro Gyogyo Kaisha, Ltd.[296], several corporations reached an agreement to contribute start-up funds and assistance to a newly formed corporation. Later one party to the agreement, a shareholder in the newly formed corporation, breached the agreement that benefited the corporation. Overruling a previous decision of the same court[297], the Supreme Court of Alaska held that the shareholder who was a party to the agreement could sue individually for breach of contract by another party shareholder, even though the plaintiff shareholder had not suffered separate and distinct injury from that suffered by the corporation.[298] The court held that:

> A shareholders agreement for the benefit of a corporation does create a duty running to both the corporation and the promisee. Section 305(1) of the Restatement (Second) of Contracts (1981) makes this clear:
> A promise in a contract creates a duty in the promisor to the promisee to perform the promise even though he also has a similar duty to an intended beneficiary.[299]

As to the remedies, the court held that 'In the event such a breach is established' the plaintiff shareholder, also a party to the agreement, 'may recover all proximate damages that can be proved with reasonable certainty'.[300]

Thirdly, a corporate fiduciary may be treated as committing torts toward the individual shareholder when 'an element of fraud or malice in the intent of the corporate official toward the shareholder was seen' and therefore a special duty to the individual shareholder may exist.[301] Nowadays, this type of a special duty is typically found where a director intentionally or negligently made deceptive misstatements to the shareholder in connection with a sale of stock, or where the stocks were issued with a wrongful intent such as diluting the interest of a specific shareholder by devaluing the shares or diluting the control already held, or preventing the exercise of control through voting at the annual meeting of shareholders.[302] Nevertheless, case law has taken different approaches as to whether the deterrence of a takeover attempt, such as the issuance of a 'poison pill' security, may also give rise to direct actions 'on the grounds that it chills voting rights or restricts the alienability of the shareholder's stock'.[303] The ALI

296 713 P.2d 1197 (Alaska 1986).
297 *Norman v. Nichiro Gyogyo Kaisha, Ltd.*, 645 P.2d 191 (Alaska 1982). The facts and the issues presented in the case were the same as those in *Hikita*.
298 *Hikita v. Nichiro Gyogyo Kaisha, Ltd.*, 713 P.2d 1197, 1200 (Alaska 1986). In this case, only the corporation suffered losses through the misconduct complained about.
299 713 P.2d 1197, 1200 (Alaska 1986).
300 713 P.2d 1197, 1201 (Alaska 1986).
301 ALI (II), Section 7.01, Reporter's Note 3, p. 29.
302 ALI (II), Section 7.01, Reporter's Note 3, pp. 29-30; ALI (II), Section 7.01, Comment C, p. 19.
303 ALI (II), Section 7.01, Reporter's Note 3, pp. 30-31.

Principles suggest that the test should be whether the shareholder suffered an injury that is independent from a prior injury to the corporation.[304]

In *Lochhead v. Alacano*[305], the defendants (directors and majority shareholders) granted themselves additional shares at inadequate prices before the merger of the corporation and forged corporate documents such as the notice of a shareholders' meeting and the meeting minutes. In his First Amended Complaint, the plaintiff alleged that the defendants had breached a fiduciary duty to him when they illegally deprived him of the value of certain stock of the purchasing corporation.[306] However, under Utah law 'as to corporate directors and officers … the duty is owed to the corporation itself and to the shareholders only collectively'[307], and 'It is for the corporation … to institute action for wrongs inflicted upon it by corporate officers or to set aside contracts made in fraud of corporate rights'.[308] Therefore, a fiduciary duty owed to an individual shareholder was not recognized and a direct action was not allowed. Nevertheless, in his Third Amended Complaint, the plaintiff changed the cause of action. The plaintiff claimed that he was directly injured by the defendants' misconduct due to the reduction in his proportionate ownership interest.[309] This injury was not indirect loss deriving from a diminution in value of the plaintiff's stocks, in fact, the overall value of the sold corporation at the time of merger was unaffected by the defendants' conduct, and neither the sold corporation nor the purchasing corporation suffered any corporate injury as a whole.[310] The plaintiff's amended claim was upheld by the court. The court accepted that the plaintiff's personal right was injured. It stated that:

> The right of a stockholder to maintain an existing proportion between his stock and the entire capital stock is a property right of which, under ordinary circumstances, he cannot be deprived by an increase of stock. A stockholder has a personal right of action to attack and avoid a fraudulent increase of stock made and issued to another which results in depriving him of his relative position as a stockholder. A suit to protect this personal, primary right is not derivative because it is not maintained in the right of the corporation or brought on its behalf.[311]

In addition, the court also acknowledged that the plaintiff's injury from the dilution of his ownership interest was direct and distinct from that of the

304 ALI (II), Section 7.01 (b), and Comment C, p. 19.
305 697 F. Supp. 406, (D. Utah 1988).
306 697 F. Supp. 406, 410 (D. Utah 1988).
307 697 F. Supp. 406, 410 (D. Utah 1988).
308 697 F. Supp. 406, 410 (D. Utah 1988).
309 697 F. Supp. 406, 410-411 (D. Utah 1988).
310 697 F. Supp. 406, 411-412 (D. Utah 1988).
311 697 F. Supp. 406, 412 (D. Utah 1988).

corporation.[312] Based on the infringed personal right and direct injury, the court allowed a direct action.

Delaware law

The derivative versus direct distinction under Delaware law was for a long time complicated and confusing. This was partly due to the fact that some courts applied the 'special injury' requirement to make a distinction while others did not.[313] The 'special injury' test required a plaintiff who claimed for a direct action to 'state a claim for an injury which was separate and distinct from that suffered by other shareholders or a wrong involving a contractual right of a shareholder which existed independently of any right of the corporation'.[314] Furthermore, 'When an injury to corporate stock falls equally upon all stockholders, then an individual stockholder may not recover for the injury to his stock alone, but must seek recovery derivatively on behalf of the corporation'.[315] Obviously the 'special injury' test confused the injury to the corporation as a separate entity with the direct injury to shareholders equally but individually. Those courts that did not adopt the 'special injury' test identified shareholder's direct claims as those where the shareholder's injury was direct or independent of any injury suffered by the corporation.[316]

The above situation may recently have changed, however. In 2004 some landmark decisions were made by the Delaware Court of Chancery and the Delaware Supreme Court.[317] In these cases, the 'special injury' test was abolished. Recognizing that the 'special injury' test was 'not helpful' and 'confusing'[318], the Delaware Supreme Court held that when determining whether the action should be direct or derivative,

> ... a court should look to the nature of the wrong and to whom the relief should go. The stockholder's claimed direct injury must be independent of any alleged injury to the corporation. The stockholder must demonstrate that the duty breached was owed to the stockholder and that he or she can prevail

312 697 F. Supp. 406, 413 (D. Utah 1988).

313 Donaldson (2005), pp. 389-396. Cases adopting the 'special injury' requirement include, for example, *Bokat v. Getty Oil Co.*, 262 A.2d 246, (Delaware 1970); while cases which did not accept the requirement include, for example, *Kramer v. Western Pac. Indus., Inc.*, 546 A.2d 348, (Delaware 1988).

314 *Grimes v. Donald*, 673 A.2d 1207, 1213 (Delaware 1996).

315 *Bokat v. Getty Oil Co.*, 262 A.2d 246, 249 (Delaware 1970).

316 Donaldson (2005), pp. 393-394; *Kramer v. Western Pac. Indus., Inc.*, 546 A.2d 348, 351 (Delaware 1988).

317 The Delaware Court of Chancery case of *Agostino v. Hicks*, 845 A.2d 1110, (Del. Ch. 2004), and the Delaware Supreme Court case of *Tooley v. Donaldson, Lufkin & Jenrette, INC.*, 845 A.2d 1031, (Delaware 2004).

318 *Tooley v. Donaldson, Lufkin & Jenrette, INC.*, 845 A.2d 1031, 1035 (Delaware 2004).

> without showing an injury to the corporation;[319]
> [The distinction] must turn solely on the following questions: (1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?[320]

Although there are still open questions, such as whether the 'special injury' test is still indicative, and how to distinguish the shareholder's injury from the corporate injury[321], the latest development in Delaware case law is indeed closer to the test of 'personal injury' doctrine or the 'special duty' doctrine that we have been discussing.

3.3.3 Special treatment for close corporations

The above mentioned distinction between direct and derivative actions applies to all corporations generally. However, the distinction may be more difficult to make in close corporations. This is at least partly due to the special treatment for close corporations given by some courts. As mentioned in Section 3.2.3.1.2, when recognizing the special features of close corporations, some courts may apply different rules to close corporations from those applied to public corporations. This different treatment may also be embodied in the distinction between direct and derivative actions.

3.3.3.1 Different approaches to the question of whether the nature of close corporations should be relevant to the distinctions in close corporations

American courts have taken different approaches to the question of whether the nature of close corporations should be relevant as far as the classification of suits is concerned. Some courts take the strict position that the distinct nature of close corporations should not be relevant.[322] An individual shareholder must bring a derivative action to claim corporate injury even if the plaintiff is the only shareholder.[323] They can only bring a direct action for injuries that are personal and distinct from those done to the corporation.[324] This approach sticks to the

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319 *Tooley v. Donaldson, Lufkin & Jenrette, INC.*, 845 A.2d 1031, 1038-1039 (Delaware 2004).

320 *Tooley v. Donaldson, Lufkin & Jenrette, INC.*, 845 A.2d 1031, 1033 (Delaware 2004).

321 Donaldson (2005), pp. 403-408.

322 DeMott (2003), Section 2:5, p. 2-35. Such a line of cases include, for example, *Hames v. Cravens*, 966 S.W.2d 244 (Arkansas 1998); *Abelow v. Symonds*, 38 Del. Ch. 572, 156 A.2d 416 (1959); and *W. E. Hedger Transportation Corp. v. Ira S. Bushey & Sons*, 186 Misc. 758, 61 N.Y.S.2d 876 (N.Y. Sup. 1945).

323 Such as *W. E. Hedger Transportation Corp. v. Ira S. Bushey & Sons*, 186 Misc. 758, 61 N.Y.S.2d 876 (N.Y. Sup. 1945).

324 DeMott (2003), pp. 2-35 – 2-36.

traditional justifications for derivative actions such as the necessity to protect the creditors and to avoid multiple suits.[325]

Nevertheless, some courts have taken a more flexible approach. Recognizing the distinct nature of close corporations, the courts are inclined to treat close corporations differently and permit direct actions in close corporations where, if in public corporations, the claimant would have brought a derivative action.[326] Several justifications are given for this approach. First, corporate recovery in derivative actions may give rise to problems in close corporations.[327] The recovery going to the corporation may still be under the control of the defendant and so the defendant majority shareholder would also indirectly benefit from the recovery based on the shares they own. In addition, the plaintiff minority shareholder may not be fully compensated by the corporate recovery. Therefore, neither the compensatory function nor the deterrent one would be achieved. Second, the justifications for a derivative action may not exist or be less substantial in close corporations.[328] For example, since there are only a small number of shareholders in such corporations, the threat of a multiplicity of suits is unlikely to happen.[329] The need to protect creditors may not be necessary if the corporation is not insolvent; seeking the intra-corporate remedy is neither necessary nor possible since a disinterested board would hardly exist in such corporations.[330] The strict requirements on initiating an action may also not be needed because such requirements aim to protect public corporations against 'strike suits' by plaintiffs holding only a nominal interest in the firm.[331] This protection may not be necessary in close corporations. This lack of justifications for a derivative action is especially the case where the shareholders in a close corporation are divided into two groups: the plaintiff minority shareholders and the defendant majority shareholders. If the corporation is still solvent, the interests of creditors will not be affected either. In such corporations, since the plaintiffs are the only injured shareholders, individual recovery will not prejudice the rights of other shareholders. Based on these considerations, it is held that 'in exceptional situations' courts 'should look at the 'realistic objectives' of a given case to determine if a direct action is proper'.[332]

The ALI also takes the flexible approach. Section 7.01(d) of the ALI's Principle states that:

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325 DeMott (2003), pp. 2-36 – 2-38.

326 DeMott (2003), pp. 2-38 – 2-43; Thompson (1993), pp. 733-738. Examples of the cases can be seen in this section.

327 O'Neal & Thompson (2004), Section 9.22 (Direct v. derivative suits; individual recovery in derivative suits), text accompanying Footnote 10.

328 ALI (II), Section 7.01, Comment E, p. 21.

329 DeMott (2003), pp. 2-38 – 2-39.

330 ALI (II), Section 7.01, Comment E, p. 21.

331 ALI (II), Section 7.01, Comment E, p. 21.

332 *Thomas v. Dickson*, 301 S.E.2d 49, 51 (Georgia 1983).

> In the case of a closely held corporation, the court in its discretion may treat an action raising derivative claims as a direct action, exempt it from those restrictions and defenses applicable only to derivative actions, and order an individual recovery, if it finds that to do so will not (i) unfairly expose the corporation or the defendants to a multiplicity of actions, (ii) materially prejudice the interests of creditors of the corporation, or (iii) interfere with a fair distribution of the recovery among all interested persons.[333]

Typical examples of a shareholder's individual cause of action in close corporations, which would be a corporate cause of action if in public corporations, may include:

- termination [of employment of the plaintiff shareholder] coupled with increased salaries and corporate benefits for the shareholders who remain;
- misuse of corporate authority to gain a greater share of proceeds when the corporation is sold;
- misappropriation of assets by the controlling shareholders;
- selling corporate assets too cheaply to controllers or related parties;
- the controllers receiving benefits in the form of increased salaries and other compensation.[334]

In fact, it is difficult for the plaintiff shareholder to accurately identify the nature of action in close corporations due to the inconsistency of case law.[335] The best solution for the plaintiff shareholder may be to bring both claims jointly or alternatively.[336] For example, the empirical study showed that in Delaware in more than half of derivative cases concerning private companies, the complaint linked an individual claim to the derivative one.[337]

3.3.3.2 Judicial grounds for allowing direct actions instead of derivative actions in close corporations

Flexible treatment of the classification of actions in close corporations may also be based on different grounds, which I will discuss in the following sections. Of

333 Cases citing Section 7.01(d) of the ALI Principles include, for example, *Schumacher v. Schumacher*, 469 N.W.2d 793 (N.D. 1991); *Barth v. Barth*, 659 N.E.2d 559, (Indiana 1995); *Norman v. Nash Johnson & Sons' Farms, Inc.* 140 N.C.App. 390, 537 S.E.2d 248 (N.C.App. 2000).

334 O'Neal & Thompson (2004), Section 9.22, text accompanying Footnotes 37-41. Also see Thompson (1993), pp. 733-734.

335 Such as with regard to the overcompensations cases, in *Sugarman v. Sugarman*, 797 F.2d 3 (1st Cir. 1986) the direct claim was sustained, while in *Bessette v. Bessette*, 385 Mass. 806, 808-810 (1982), the direct claim was rejected.

336 Billings (1996), p. 12.

337 Thompson & Thomas (2004), p. 1765.

course, the court may apply more than one ground to justify the identification of the action.

3.3.3.2.1 New causes of direct action and the varied injury criterion

As mentioned in Section 3.2.3.4, many states have developed two remedies for minority shareholders in close corporations in order to grant individual shareholders the right to bring direct actions against the majority shareholder's oppression: the statutory remedy of the broadened involuntary dissolution and the common law remedy of enhanced fiduciary duties owed by the controlling shareholder to other shareholders directly. If the plaintiff shareholder can prove that the misconduct amounted to 'oppression' in the statutory remedy or breached the common law fiduciary duty owed to him, he may bring a direct action against the misconduct in his own name based on these causes of action.

An individual shareholder may seek the above remedies even if the same misconduct also injures the corporation and gives rise to a derivative action simultaneously.[338] In such cases, the misconduct also has twin aspects: it has infringed on both the rights of the corporation and those of the plaintiff shareholder. As in cases of *ultra vires* or the unauthorized act, traditionally the identification of action in such cases depends on the plaintiff's complaints or the remedies sought by the plaintiff. A direct action can be brought if the shareholder seeks the prevention or enjoining of the oppression or an exit remedy.[339] Nevertheless, a direct action may not be allowed if a claim is made by the shareholder for damages against losses that are reflective of the corporate losses.

However, some courts may treat close corporations in a special way and adopt a varied injury criterion to allow a shareholder's direct action for damages where the injury was to the corporation and, therefore, would only give rise to a derivative action if in public corporations. For example, where the misconduct injured the corporation but benefited the majority shareholders, the traditional view is that the injury was suffered by the corporation, while shareholders individually only bore indirect losses; therefore an individual shareholder can only bring a derivative action for damages. Nevertheless, in close corporations some courts have accepted that in such cases the minority shareholders have suffered losses separate and distinct from those suffered by the majority shareholders, which would give rise to the minority shareholders' direct actions.[340] Actually, in such cases the courts focus on 'the disproportionate

338 Generally courts allow shareholders to maintain derivative and direct actions simultaneously.

339 See ALI (II), Section 7.01, Reporter's Note 1, p. 27.

340 See, for example, *Norman v. Nash Johnson & Sons' Farms, Inc.*, 140 N.C.App. 390, 537 S.E.2d 248 (N.C.App., 2000); *Dowling v. Narragansett Capital Corp.*, 735 F. Supp. 1105 (D.R.I. 1990); *Crosby v. Beam*, 548 N.E.2d 217 (Ohio 1989); *Traylor v. Marine Corp.*, 328 F. Supp. 382 (E.D. Wis. 1971).

impact' of the misconduct on the minority shareholders rather than the injury to the corporation.[341] In *Sugarman v. Sugarman*[342], where the majority benefited his father and himself through unequal salaries and overcompensation not available to the minority shareholders and where the majority offered to buy out the minority at an inadequate price, the First Circle of the Federal Court of Appeal did allow the direct action based on the 'freeze-out' theory and granted direct damages to the plaintiffs. In *Norman v. Nash Johnson & Sons' Farms, Inc.*[343], where the defendants diverted assets and business opportunities from the Company to the defendants and therefore enriched themselves at the expense of the Company and the plaintiffs, the Court of Appeals of North Carolina also acknowledged that:

> … plaintiffs have sufficiently alleged that they have suffered an injury 'separate and distinct' from the injury sustained by the other shareholders or the corporation itself …
> The gist of plaintiffs' allegations is that they have suffered substantial financial losses as the result of the defendants' actions, while the defendants have obviously profited from those same wrongful acts. Plaintiffs have sufficiently alleged that they have suffered injuries 'separate and distinct' from the defendants, who have suffered no injuries at all.

In *Crosby v. Beam*[344], where the controlling shareholders received benefits in the form of increased salaries and other compensation, the Supreme Court of Ohio allowed a direct action. The court held that the shareholders in close corporations owed heightened fiduciary duty to each other and that the controlling shareholders had breached such duty 'to minority shareholders when control of the close corporation is utilized to prevent the minority from having an equal opportunity in the corporation.' Where such a breach has occurred, the minority shareholder was individually harmed even where there were no special damages peculiar to the minority shareholder and, therefore, a minority shareholder might then proceed with a direct action against the offending majority or controlling shareholders.[345] The court also pointed out that 'a derivative remedy is not an effective remedy because the wrongdoers would be the principal beneficiaries of the recovery'.[346] Therefore, in this case, although there was a non-party shareholder, the court still allowed a direct action against the controlling shareholders' misconduct.

However, some courts take a stricter approach when identifying the action. According to them, the 'disproportionate impact' of the misconduct on the

341 O'Neal & Thompson (2004), Section 9.22.

342 For a discussion of this case, see also Section 3.2.3.4.3.

343 140 N.C.App. 390, 537 S.E.2d 248 (N.C.App., 2000).

344 548 N.E.2d 217 (Ohio 1989).

345 548 N.E.2d 217, 220-221 (Ohio 1989).

346 548 N.E.2d 217, 221 (Ohio 1989).

plaintiff shareholder is not enough to support a direct action. On the contrary, the plaintiff shareholder must establish 'freeze-outs' in order to bring a direct claim. For example, in *Bessette v. Bessette*, the Supreme Judicial Court of Massachusetts held that overcompensation alone could not be cognizable injury to the shareholder and so warrant a derivative action to redress it.[347] In *Crosby v. Beam*, Justice Wright, as a minority, also gave his dissenting opinion that where the controllers used their control to deprive minority shareholders of their investment, a direct action could only be brought 'where the plaintiff can demonstrate an effort to 'freeze him out' as a stockholder or where he is directly affected through loss of dividends, company employment or the like'. If this is not the case, then derivative action rules should be inapplicable.[348]

3.3.3.2.2 The concern that justifications for derivative actions may not exist in close corporations

Some cases have recognized that there should be an exception to the general rule of distinction 'which looks to the reasons requiring derivative actions to determine if they are applicable'.[349]

In *Thomas v. Dickson*[350], the controlling shareholders of a close corporation paid themselves increased salaries rather than distributing dividends to all shareholders. When deciding whether a shareholder's direct action should be permitted regarding this overcompensation, the Supreme Court of Georgia realized that 'in exceptional situations this Court and our other State Courts should look at the 'realistic objectives' of a given case to determine if a direct action is proper'.[351] In this case, the court held that the reasons requiring derivative actions did not exist. Since the plaintiff was the sole injured shareholder, there could be no multiplicity of lawsuits and there was no consideration that the direct recovery would prejudice the rights of other shareholders. Since the benefit of corporate recovery to an individual shareholder lay in the increase in the value of his shares and since there was no ready market for the shares in the close corporation, the plaintiff shareholder would not have been adequately compensated if a corporate recovery were to be granted. Additionally, in this case the protection of creditors did not exist either.[352] Justice Smith went even further in this case. He gave his own opinion that:

> It would be a serious error to limit direct actions for recovery of misappropriated corporate funds to cases where only one shareholder is injured,

347 385 Mass. p. 806, 808-10 (1982).
348 *Crosby v. Beam*, 548 N.E.2d 217, 222-223 (Ohio 1989).
349 *Thomas v. Dickson*, 301 S.E.2d 49, 51 (Georgia 1983).
350 301 S.E.2d 49 (Georgia, 1983).
351 301 S.E.2d 49, 51 (Georgia, 1983).
352 301 S.E.2d 49, 51 (Georgia, 1983).

> or to declare flatly that such actions lie only in the context of closely held corporations. ... In my view a direct action should be available, where justice requires, based on a careful evaluation of the facts of each case.[353]

As mentioned, the ALI Principles also took the same approach in Section 7.01(d).[354]

3.3.3.2.3 Prevention of unjust enrichment

Prevention of unjust enrichment to the wrongdoing shareholders is also a ground for the court to allow a direct action in the case of corporate injury. In *Crosby v. Beam*, one of the reasons that the court declined to award a derivative action, although it was not the most important reason, was that 'a derivative remedy is not an effective remedy because the wrongdoers would be the principal beneficiaries of the recovery'.[355]

The Delaware Court of Chancery has also applied the 'unjust enrichment exception' to classify actions in some cases.[356] In *Fischer v. Fischer*[357], the defendant shareholders caused the corporation to sell real estate too cheaply to another entity owned by the defendants; the plaintiff shareholder was the only shareholder in the corporation who did not have any ownership in the third entity and so suffered losses as a result. Vice Chancellor Steele, as he was then, held that in such a case the plaintiff was allowed to bring a direct action since she suffered special injury distinct from that suffered by the other shareholders.[358] In addition:

> ... if I were to dismiss plaintiff's individual claims, I would place plaintiff in the awkward position of continuing a purely derivative action with any relevant relief benefiting Fischer Enterprises alone. An eventual victory for plaintiff, would achieve little since the individual defendants own an overwhelming interest in [the nominal defendant corporation]. The pleaded fundamental wrong alleged underlies both the asserted individual and derivative claims. Equity's appropriate focus should be the alleged wrong, not the nature of the claim which is no more than a vehicle for reaching the remedy for the wrong. As equity will not suffer a wrong without a remedy, I must permit plaintiff's individual claims to proceed.[359]

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353 301 S.E.2d 49, 52 (Georgia, 1983).

354 For the details of Section 7.01(d) of the ALI Principles, please see Section 3.3.3.1.

355 548 N.E.2d 217, 221 (Ohio 1989).

356 *In re Cencom Cable Income Partners, L.P.*, 2000 WL 130629 (Jan. 27, 2000), *In re Gaylord Container Corp. Shareholders*, 747 A.2d 71, 81 (Del. Ch.1999), and *Fischer v. Fischer*, 1999 WL 1032768, (Del. Ch. Nov. 4, 1999).

357 1999 WL 1032768, (Del.Ch. Nov. 4, 1999).

358 1999 WL 1032768, (Del.Ch. Nov. 4, 1999), at p. 3.

359 1999 WL 1032768, (Del.Ch. Nov. 4, 1999), at p. 4.

Nevertheless, in *Agostino v. Hicks*, the Delaware Court of Chancery did not apply the 'unjust enrichment exception', partly on the basis that it 'would only add to the confusing ambiguities surrounding the direct/derivative distinction'.[360]

3.3.3.2.4 The procedural ground

Another reason that some courts permit a direct action in the case of corporate injury is the procedural ground: there will be no remedy if only a derivative action is allowed where the corporation has been sold or dissolved.[361] For example, in *Watson v. Button*[362], one former shareholder of the corporation discovered misappropriation of the corporate assets by the other former shareholder, who was also a general manager, after the corporation was sold to a third party. The misappropriation happened before the sale of the corporation and led to joint liability for both shareholders. The plaintiff shareholder could not bring a derivative action against the misappropriation since he was not a shareholder anymore and the corporate cause of action was given up by the present owner of the corporation. Finding that in the current case the justifications for a derivative action did not exist, since, for example, no rights of creditors or other shareholders would be prejudiced, and there was no possibility of a multiplicity of suits, the Ninth Circuit of the Federal Court of Appeals, affirming the judgment of the District Court for the District of Oregon, allowed the direct action initiated by the plaintiff shareholder and awarded an individual recovery to him. *Kirk v. First Nat. Bank of Columbus* seemed to go further.[363] It allowed former shareholders to bring a direct action against the corporate injury where there were non-party shareholders.

3.3.3.2.5 Other concerns

In *Barth v. Barth*[364], the Supreme Court of Indiana set new standards for the distinction. First, the court should consider 'whether the corporation has a disinterested board that should be permitted to consider the lawsuit's impact on the corporation'.[365] Second, the court should consider whether permitting a direct action will also benefit the corporation. For example, in a direct action the defendant can also file a counterclaim against the plaintiff, even though such a counterclaim is normally not allowed in a derivative action. Third, the legal expenses should also be considered: in a derivative action, the successful plaintiff generally will be allowed to recover attorneys' fees from the corporation while in

360 845 A.2d 1110, 1125 (Del. Ch. 2004).
361 Thompson (1993), p. 734.
362 235 F.2d 235 (9th Cir. 1956).
363 439 F. Supp. 1141 (M.D.Georgia 1977).
364 659 N.E.2d 559, 562-563 (Indiana 1995).
365 Also see ALI (II), Section 7.01, Comment E.

a direct action the plaintiff shareholder has to pay his own attorneys' fees even if he succeeds.[366]

3.3.4 *Direct pro rata recovery to the individual shareholder in derivative actions*

As mentioned, in situations where the award of corporate recovery in derivative actions will benefit the wrongdoer majority shareholders as well and incompletely compensate the injured shareholders, the court may flexibly allow a direct action instead of a derivative one. Nevertheless, this is not the only solution for these cases where the corporate recovery is not appropriate. In fact, American case law sometimes awards direct *pro rata* recovery to the individual shareholders in derivative actions. Although this issue does not relate to the distinction problem, it is still worthy of discussion here.

In a few derivative action cases, American courts may award direct *pro rata* recovery, which reflects the percentage of their shares, to the individual shareholders instead of awarding corporate recovery. This direct *pro rata* recovery in derivative actions should be distinguished from the direct damages in a shareholder's direct action. When deciding whether to award direct *pro rata* recovery or corporate recovery, the court normally will consider factors such as whether the creditors' interests will be unfairly affected, whether the wrongdoers still have control of the company, whether the wrongdoing shareholders will get windfalls, or whether the direct *pro rata* recovery will facilitate the distribution of corporate funds.[367] Those special situations where the court will grant direct *pro rata* recovery include: (1) where the corporation is in the process of liquidation, (2) where the wrongdoers retain control of the corporation and so a corporate recovery would revert to their control, (3) where the defendants sell corporate control for an unlawful premium and the purchasers of these wrongdoers' shares would acquire windfalls via a corporate recovery, (4) where a majority of the shareholders will not bring derivative actions because they are personally involved in the wrongdoing or have ratified the wrongdoing, and (5) where the shareholders are differently situated and a direct *pro rata* recovery would fairly resolve the differences.[368]

Nevertheless, a direct *pro rata* recovery may pose the problem of interfering with corporate management because, if the recovery goes back to the corporation, it would be a corporate business decision whether to distribute the fund to the shareholders or keep it for corporate business purposes.[369] In addition, a direct *pro rata* recovery may give rise to procedural issues. For example, *res judicata*

366 *Barth v. Barth*, 659 N.E.2d 559, 562-563 (Indiana 1995). As to a further discussion of the allocation of litigation costs, please refer to Section 3.4.4.1.

367 Cox & Hazen (2002), Chapter 15.03, p. 425.

368 Cox & Hazen (2002), Chapter 15.03, pp. 425-426.

will not bar non-party shareholders; some courts have denied attorneys' fees to successful plaintiffs in derivative actions simply because the recovery went to the shareholders rather than the corporation.[370] In point of fact, American courts only apply the direct *pro rata* recovery in special situations and 'do not lend themselves to generalization or abstraction into a rule'.[371]

3.4 Striking a balance between corporate efficiency and protection for the corporation and the minority shareholders

Under American law each single shareholder *prima facie* has the right to initiate a derivative action against corporate misconduct. Nevertheless, this right is subject to several substantive and procedural restrictions, such as the business judgment rule and the demand requirement. In the end, both by facilitating and controlling derivative actions, American law does try to strike a fair balance between corporate efficiency and protection for the corporation and the minority shareholders.

3.4.1 Substantive limitations to the scope of derivative actions

3.4.1.1 Whose misconduct may lead to a derivative action

Causes of derivative action under American law may arise from a breach of duties to the corporation by a wide range of persons, including a third party who owes duties other than fiduciary duties to the corporation.[372] This wide scope for causes of action may be due to the historical development of American derivative action rules. As mentioned in Section 3.1.1, originally derivative actions were often applied against third parties such as tax collectors.

Nevertheless, the requirements for bringing derivative actions, such as the demand requirement and the lenient approach of judicial review of the board's litigation decision, actually make it difficult for an individual shareholder to challenge any breach of duties by persons other than corporate fiduciaries.[373] In fact, in the United States derivative actions are mainly initiated against corporate fiduciaries such as directors, officers or controlling shareholders instead of against third parties.

369 Note (1956), p. 1319.
370 Cox et al. (2001), Chapter 15.4, p. 15.33.
371 DeMott (2003), Section 7:6, p. 7-45.
372 DeMott (2003), Section 1:1, p. 1-2.
373 For details on these requirements, see Section 3.4.2.

3.4.1.2 Nature of the defendant's misconduct that may lead to a derivative action: the business judgment rule

3.4.1.2.1 Introduction to the business judgment rule

The business judgment rule may also play a role as a substantive restriction on a shareholder's right to derivative actions. Although American rules on derivative actions do not explicitly restrict the application of derivative actions to certain misconduct, American courts in fact rarely hold the corporate directors or officers liable for mere negligence. This situation may result, at least partly, from the application of the business judgment rule.[374]

The business judgment rule is a judge-made principle widely adopted in the US. The most oft-cited expression of the rule is that given by the Delaware Supreme Court: it is 'a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company'.[375]

Although formulations and judicial applications of the rule do vary[376], the basic feature of the rule is that, when evaluating a business decision, the court should principally examine the process or procedure by which the decision was made instead of examining the merits or the substantive aspect of the decision (the outcome or quality of the decision), although the test of 'rational belief' does include a certain degree of examination of the substantive aspect.[377] Effectively, the rule acts as a shield to protect directors from liability for their decisions if they satisfy the requirements of the rule, such as having acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company, even though the decision may have turned out badly from the perspective of the corporation.[378] The rule also has an effect on the validity of the decision in addition to the director's liability: a rational decision made with due process will be valid and binding on the corporation even if it turns out badly later.[379] Nevertheless, I will only focus on the rule's effect on the director's liability since the issue of the validity of a decision is beyond the scope of this book.

The business judgment rule plays a pivotal role in derivative actions. The function this rule plays in derivative actions is twofold. First, it decides under what

374 Bradley & Schipani (1989), p. 23.

375 *Aronson v. Lewis*, 473 A.2d 805, 812 (Delaware 1984). See also *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Delaware 1985); *Brehm v. Eisner*, 746 A.2d 244, 264 (Delaware 2000).

376 For a detailed discussion of the formulation and judicial application of this rule, please refer to Section 3.4.1.2.3 and Section 3.4.1.2.4, respectively.

377 Hamilton (2000), p. 455; Veasey & Guglielmo (2005), p. 1449.

378 Hamilton (2000), p. 455; Ferrara et al. (2005), S 5.01.

379 Hamilton (2000), p. 453.

circumstances the director will be held liable for his breach of duties, or in other words, it limits the director's liability for certain kinds of breach of duties. Although directors owe fiduciary duties to the corporation, not every breach may give rise to director's liabilities according to the rule. Second, the rule is also applied to review the litigation decision of the board and in some states the decision of the special litigation committee. Since a litigation decision is also a business decision, it should be governed by this rule as well. In this section, I will only discuss the first application of the rule. The second type of application will be discussed in Section 3.4.2.2.2.3.

3.4.1.2.2 Rationale for and necessity of the rule

The standard of conduct versus the standard of liability (or the standard of review)

The business judgment rule in fact establishes a standard of liability (or a standard of judicial review) which is different from the standard of directors' conduct. As we know, directors bear the fiduciary duty of loyalty and duty of care when managing the corporation. However, this fiduciary duty is only a standard of conduct for directors rather than 'the operative test for determining whether directors are liable for damages for failing to exercise reasonable care'.[380] The appropriate test for liability is the business judgment rule. These different standards of conduct and of liability are generally recognized by the MBCA[381], the ALI Principles[382], as well as by Delaware law.

The question may arise as to why there should be a standard of liability separate from the standard of conduct for directors. This phenomenon of separation of standards is not very common. The fact is that in most areas of law, such as those regarding the liability of drivers or of agents, the two standards are identical, and so people often ignore the difference.[383]

Rationale for and necessity of the business judgment rule

According to Eisenberg 'whether the two standards are or should be identical in any given area is a matter of *prudential* judgment.'[384] He points out that:

> Perhaps standards of conduct and standards of review in corporate law would always be identical in a world in which information was perfect, the risk of

380 Hamilton (2000), p. 449.

381 The 1999 amendments to the MBCA added a new Section 8.31 entitled 'standards of liability for directors,' as distinguished from Section 8.30 entitled 'standards of conduct for directors.'

382 See ALI (I), Section 4.01(a) and (c).

383 Eisenberg (1993), p. 437.

384 Eisenberg (1993), p. 437.

> liability for assuming a given corporate role was always commensurate with the incentives for assuming the role, and institutional considerations never required deference to a corporate organ. In the real world, however, these conditions seldom hold, and the standards of review in corporate law pervasively diverge from the standards of conduct.[385]

There have been many elucidations of the rationale for and the necessity of the business judgment rule.[386] Several points may account for the rule. First, it is accepted that directors rather than shareholders are granted discretion in managing the corporation; this discretion, if rationally exercised, should not be submitted to judicial review.[387] Second, it is also acknowledged that there are inherent risks in business decisions due to reasons such as insufficient information or unexpected changes in events. Therefore, the evaluation of business decisions should focus on the process of decision-making rather than on the merits with the benefit of hindsight.[388] In this way, directors are also encouraged to take entrepreneurial risks that may result in high profits for the corporation in return.[389] Third, due to the high risks of business decisions and the serious losses a bad decision may cause, a qualified person will be less willing to serve as a director if it is probable that he will find himself faced with liabilities for his directorial decisions. Moreover, the higher risk of a director's liability may also lead to higher costs for the corporation since, for example, the corporation may have to pay more for the director's liability insurance.[390] Last but not least, the business judgment rule also reflects the tradition that courts will not interfere in business matters (or in other words, will not second-guess the business decisions of directors) since judges are not business experts and are less qualified than directors to cope with business issues.[391]

In short, the above points reveal the central purpose of the business judgment rule, which is also the central purpose of corporate governance.[392] The business judgment rule attempts to strike a balance between the two competing policies on a case-by-case basis: one is the need to preserve the director's decision-making discretion as well as corporate efficiency, and the other is the need to make the wrongdoing directors liable while protecting the corporation and investors.[393]

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385 Eisenberg (1993), pp. 437-438.

386 See, for example, Hamilton (2000) p. 449, p. 454; Ferrara et al. (2005), Section 5.02; ALI (I), Part IV, Chapter 1, Introductory Note A, p.135; Veasey & Guglielmo (2005), pp. 1422-1423.

387 Hamilton (2000), p. 454; Ferrara et al. (2005), Section 5.01.

388 Hamilton (2000), p. 449.

389 Veasey & Guglielmo (2005), pp. 1422-1423.

390 Hamilton (2000), p. 449. See also the empirical study of the immediate effects on the market regarding director and officer liability insurance by *Smith v. Van Gorkom* and section 102(b)(7) of DGCL (Westlaw: 8 Del. Code Ann. s 102(b)(7)); see Bradley & Schipani (1989).

391 Hamilton (2000), p. 454; Ferrara et al. (2005), Section 5.02.

392 Bainbridge (2004), p. 84.

393 Bainbridge (2004), p. 84.

3.4.1.2.3 Prerequisites for applying the business judgment rule (formulations or elements of the rule)

The business judgment rule is regarded as 'one of the least understood concepts in the entire corporate field'.[394] This difficulty is embodied, at least partly, in the formulations of the rule and the judicial approaches to the application of the rule. I will discuss the former issue in this section and the latter one in the next section.

As mentioned, the business judgment rule shields directors from liabilities in certain situations even if their actions have caused damage to the corporation. The issue, therefore, is what the prerequisites of the rule are. Or, in other words, under what circumstances may directors be shielded from liabilities. Although the specific formulations of the rule vary, normally the rule will be applicable if a director acted on an informed basis, in good faith and rationally believed that the action was being taken in the best interests of the company. For example, Section 4.01(c) of the ALI Principles states that:

> A director or officer who makes a business judgment in good faith fulfills the duty under this Section if the director of officer:
> (1) is not interested in the subject of the business judgment;
> (2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and
> (3) rationally believed that the business judgment is in the best interests of the corporation.

The newly added MBCA Section 8.31, entitled 'Standards of Liability', also states that in order to be protected from liability, the director should act in good faith, should reasonably believe that the decision was in the best interests of the corporation, should be informed to an extent the director reasonably believed appropriate under the circumstances, should make the decision objectively and independently, and should not receive a financial benefit to which the director was not entitled, and so on.

Delaware law also includes prerequisites similar to those in the ALI Principles or the MBCA. In *Brehm v. Eisner*, the Delaware Supreme Court restated that:

> The business judgment rule has been well formulated by Aronson and other cases. See, e.g., Aronson, 473 A.2d at 812 ('It is a presumption that in making a business decision the directors ... acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the corporation.'). Thus, directors' decisions will be respected by courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational

394 Manne (1967), p. 270.

business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available.[395]

Prerequisite of a positive action

It is generally agreed that in order to be protected by the business judgment rule, directors must take positive action. 'Business judgment' means that 'a decision must have been consciously made and judgment must, in fact, have been exercised'.[396] Therefore, abdication of their duties and simply doing nothing will not be protected by the rule. Nevertheless, a positive decision not to do anything will be protected if other prerequisites are also satisfied since this involves conscious judgment.[397] An informed delegation of authority may also amount to business judgment.[398]

Prerequisite of being uninterested in the subject of the business judgment or being independent when making the decision (Prerequisite of no conflict of interest)

The business judgment rule does not apply when the director is self-interested with respect to the transaction. If the plaintiff shareholder can establish that it is a conflicted interest transaction, the business judgment rule may be rebutted. However, the interested director may be shielded from liability under certain circumstances: if the interested director can establish that the conflicted interests transaction has been authorized by a majority of the disinterested directors or by a vote of the disinterested shareholders after a full disclosure, the business judgment rule will apply again; in addition, the interested director can also be discharged from liability if he can prove that the transaction is entirely fair to the corporation.[399]

In order for the board's decision to be protected by the business judgment rule, a majority of the directors must also make their decisions independently, without the dominance or control of the person who was interested in the transaction.[400]

Prerequisite of an informed decision

A widely accepted prerequisite for being protected by the business judgment rule is that the director must make an informed decision.[401] This requirement for an

395 *Brehm v. Eisner*, 746 A.2d 244, 264, Footnote 66 (Del.Supr. 2000).

396 ALI (I), Section 4.01, Comment to s 4.01(c), c, p. 174.

397 Hamilton (2000), p. 454.

398 See, for example, *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929 (Delaware 1985); *Canal Capital Corp. v. French*, 1992 WL 159008 (Del. Ch., 1992). Also see Ferrara et al. (2005), Section 5.03, [1], Footnote 2.

399 See, for example, DGCL s144(a) (Westlaw: 8 Del. Code Ann. s 144(a)); MBCA ss8.61(b), 8.62, 8.63; Bainbridge (2002), pp. 310-320.

400 Ferrara et al. (2005), Section 5.03, [2] [b].

401 See, for example, ALI (I), Section 4.01, Comment to s 4.01(c), e, p. 177.

informed decision reflects the attitude that the business judgment rule focuses on the process of the decision rather than on the quality of the decision: the requirement 'focuses on the preparedness of a director or officer in making a business decision'.[402] Specifically, directors must make their decisions on the basis of 'all material information reasonably available to them'.[403] In order to do that, a director must gather and consider material information with reasonable diligence and take adequate time to consider the decision.[404] If 'grossly negligent', the director will not be protected by the business judgment rule.[405]
In making a decision, it is possible and necessary for the director to rely on information, such as reports and opinions, provided by other directors, officers and employees of the corporation, as well as by outside professionals and experts. If such reliance is in good faith, the director's decision will be protected by the business judgment rule.[406]

Prerequisite of the 'rational belief'

The ALI Principles and many Delaware cases have recognized that the 'rational belief' is a prerequisite to the application of the business judgment rule.[407] The 'rational belief' means that, when performing his duty, the director must truly believe that the action is in the best interests of the corporation and the belief must be objectively rational. In fact, the test has both a subjective and an objective perspective, and includes a certain degree of examination of the substantive aspect of the director's decision.[408]

Courts may also use terms such as 'reckless disregard' or 'recklessness' or 'gross negligence' instead of the 'irrational belief'.[409] No matter what terms are applied, they generally give directors more discretion and protection than the term of 'reasonableness.' By using the 'rational belief', the ALI and many courts intend to give directors greater latitude for their business judgment.[410] Actually,

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402 ALI (I), Section 4.01, Comment to s 4.01(c), e, p. 177.
403 *Aronson v. Lewis*, 473 A.2d 805, 812 (Delaware 1984).
404 *Smith v. Van Gorkom*, 488 A.2d 858 (Delaware 1985); *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 274 (2d Cir. 1986); Ferrara et al. (2005), Section 5.03, [3], text accompanying Footnote 46.
405 *Smith v. Van Gorkom*, 488 A.2d 858, 874-879 (Delaware 1985).
406 See, for example, DGCL s 141(e) (Westlaw: 8 Del. Code Ann. s 141(e)); *Brehm v. Eisner*, 746 A.2d 244 (Delaware 2000); also see Ferrara et al. (2005), Section 5.03, [3], Footnote 47.
407 Such as *Parnter v. Marshall Field & Co.*, 646 F.2d 271, 293 (7th Cir. 1981), *Unocal Corp v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Delaware 1985), and *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Delaware 1971); see ALI (I), Section 4.01, Comment to Section 4.01(c), f, p. 179.
408 ALI (I), Section 4.01, Comment to Section 4.01(c), f, p. 179; Hamilton (2000), p. 455.
409 ALI (I), Section 4.01, Comment to Section 4.01(c), f, p. 180.
410 ALI (I), Section 4.01, Comment to Section 4.01(c), f, p. 180.

the ALI rejected both the stricter approach of accountability in the 'reasonableness' test and the more lenient approach of a purely subjective good faith test that shields an objectively irrational action from liability.[411]

Prerequisite of good faith

Although 'good faith' is a well-recognized requirement for applying the business judgment rule, its meaning is indeed very unclear. Knowingly acting to cause a corporation to violate the law surely breaches the duty of 'good faith'.[412] Nevertheless, 'good faith' has a much wider meaning than that. In *Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, L.P.*[413], the Supreme Court of Delaware distinguished 'bad faith' from 'fraud.' It quoted the definition in Black's Law Dictionary 72 (5th ed. 1983)) on 'bad faith':

> [The] term 'bad faith' is not simply bad judgement or negligence, but rather it implies the conscious doing of a wrong because of dishonest purpose or moral obliquity; it is different from the negative idea of negligence in that it contemplates a state of mind affirmatively operating with furtive design or ill will.[414]

In *Nagy v. Bistricer*[415], the Delaware Court of Chancery suggested two elements of the duty of good faith: first, a director should not act disloyally, even if for reasons other than his personal pecuniary interest; second, a director should not consciously ignore his duties to the corporation, no matter what his motive.[416] Veasey, the former chief justice of the Delaware Supreme Court, together with Guglielmo, defines good faith in a broader sense:

> Whether good faith is an objective standard, a subjective standard, or a placeholder, it means that directors must not act irrationally, irresponsibly, disingenuously, or so unreasonably that no reasonable director would accept the decision or conduct. It demands an honesty of purpose and does not tolerate the disingenuous conduct of a director who appears or claims to act for the corporate good, but who truly does not care for the constituents to whom she owes a fiduciary duty.[417]

411 ALI (I), Section 4.01, Comment to Section 4.01(c), f, pp. 180-181.
412 ALI (I), Section 4.01, Comment to s 4.01(c), d, p. 177.
413 624 A.2d 1199, (Delaware 1993).
414 624 A.2d 1199, 1208, Footnote 16 (Delaware 1993).
415 770 A.2d 43, (Del. Ch. 2000).
416 770 A.2d 43, 48, Footnote 2, (Del. Ch. 2000).
417 Veasey & Guglielmo (2005), p. 1453.

Historically, a director only had twofold duties which already subsume the duty of good faith: the duty of loyalty and the duty of care.[418] Although the principle of 'good faith' has been 'an immutable ingredient of the business judgment rule' in Delaware law[419], it has not been common for the court to separately examine the issue of good faith. The examination of the duty of loyalty and the duty of care already covered the good faith issue.[420] Nevertheless, recent Delaware cases have shown a trend towards courts specifically paying attention to the issue of 'good faith' when applying the business judgment rule to decide directors' liability.[421]

The separate focus on the issue of 'good faith' has generated the argument that there is a free-standing duty of good faith and, therefore, the director's fiduciary duty is a triad, threefold instead of twofold: the duty of loyalty, the duty of care and the duty of good faith. Nevertheless, Veasey and Guglielmo hold that it may be difficult to clearly distinguish the bad faith case and the gross negligence case in practice and doubts the importance of labeling the duty.[422] Instead, they posit that 'The real issue is understanding the definition, scope, and operational application of the amorphous concept of good faith'.[423] After analyzing the meaning of 'good faith,' they think that this new trend toward focusing on 'good faith' is a judicial reaction to Section 102(b)(7) of Delaware General Corporation Law 1986 and there is nothing new in this concept[424]:

> Good faith has been in our law for decades and is not a new concept. Thus, it should not now have any more sharp edges than it has always had. It has come to the fore recently as a result of fresh insights into the expected processes of directors in modern times and because of more precise pleading. The new realization is that the 1986 statute, section 102(b)(7), will not permit exoneration for directors who do not act in good faith. We will just have to see how it plays out in the Delaware Supreme Court.[425]

418 But there have been different approaches as to which limb the duty of good faith belongs. For example, the ALI held that good faith is an aspect of duty of care, see ALI (I) Section 4.01(a); but Bradley and Schipani, as well as others, held that the duty of loyalty includes a director to 'act in good faith and in the honest belief that the action taken is in the best interests of the corporation'; Bradley & Schipani (1989), p. 25.

419 Veasey & Guglielmo (2005), p. 1442.

420 Hintmann (2005), pp. 579-580.

421 See for example, *McCall v. Scott*, 239 F.3d 808 (6th Cir. 2001), *In re the Abbot Laboratories Derivative Shareholders Litigation*, 325 F.3d 795 (7th Cir. 2003), and *In re Walt Disney Co. Derivative Litigation*, 825 A.2d 275 (Del. Ch. 2003). For a detailed discussion of the issue, please refer to Hintmann (2005).

422 Veasey & Guglielmo (2005), pp. 1447-1448, p. 1451.

423 Veasey & Guglielmo (2005), pp. 1447-1448, p. 1452.

424 As to Section 102(b)(7) of the 1986 statute, please see Section 3.4.5.1.

425 Veasey & Guglielmo (2005), pp. 1447-1448, pp. 1453-1454.

3.4.1.2.4 Judicial applications of the business judgment rule

Substantive and procedural aspects of the rule

The business judgment rule has both substantive and procedural aspects. The substantive aspect prevents the court from interfering with corporate business matters. This substantive aspect reflects the rationale behind the rule. It is also consistent with the English rule that the court will not interfere in business matters. In fact, this substantive aspect of no judicial interference in corporate matters has been widely accepted in Western jurisdictions.

The rule also has its procedural aspect. It creates a presumption that in making his business judgment, a director or officer is fulfilling the required fiduciary duties to the corporation. If he wants to rebut the presumption of the rule, the plaintiff must prove that the director or officer did not satisfy the prerequisites of the rule, that is, that the director or officer did not act on an informed basis, in good faith, or in the honest belief that the action was in the best interest of the corporation. As a result, the rule places the burden on the plaintiff to prove that the director did not satisfy the prerequisites of the rule.

The traditional approach of judicial application of the rule as an abstention doctrine (a safe harbor rule)

Both traditional Delaware case law and the ALI Principles take the approach that the rule performs as an abstention doctrine or safe harbor rule.[426] This concept is such that the presumption created by the business judgment rule that directors have fulfilled their fiduciary duty actually builds a safe harbor for the directors and lays down hurdles for the complaining party to initiate a suit against them. Unless the plaintiff can rebut the rule by proving a breach of any of the pre-requisites of the rule, the court will abstain from reviewing the substantive merits of the director's business decision. Hence, by applying the business judgment rule as an abstention doctrine, the court has in fact subsumed the substantive aspect into the procedural one.

However, if the plaintiff can prove non-satisfaction of one of the prerequisites, the business judgment rule will not be applied. The court will hear the case, but based on other standards such as the 'entire fairness' standard.[427] The burden of proof also shifts from the plaintiff to the defendants.[428] A further discussion of these standards is beyond the scope of this book.

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426 Veasey & Guglielmo (2005), p. 1422; ALI (I), Chapter IV, comment to S 4.01(c), a, p.173; Bainbridge (2004).

427 Veasey & Guglielmo (2005), pp. 1428-1429; Ferrara et al. (2005), Section 5.01 [2].

428 Veasey & Guglielmo (2005), pp. 1428-1429; Ferrara et al. (2005), Section 5.01 [2].

The judicial approach taken in Cede & Co. v. Technicolor, Inc.

The recent Delaware case of *Cede & Co. v. Technicolor, Inc.* has taken a different approach from the traditional one.[429] According to *Technicolor* (also referred to as *Cede*), if the plaintiff shareholder can establish that the defendant director breached any one of the triads of his fiduciary duty (loyalty, duty of care or good faith, he is entitled to initiate an action against the director. This scope of actionable breach is much wider than the traditional prerequisites of the business judgment rule, which we mentioned in Section 3.4.1.2.3. The court held that:

> Thus, a shareholder plaintiff challenging a board decision has the burden at the outset to rebut the rule's presumption ... To rebut the rule, a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the triads of their fiduciary duty (good faith, loyalty or due care ... If a shareholder plaintiff fails to meet this evidentiary burden, the business judgment rule attaches to protect corporate officers and directors and the decisions they make, and our courts will not second-guess these business judgments ... If the rule is rebutted, the burden shifts to the defendant directors, the proponents of the challenged transaction, to prove to the trier of fact the 'entire fairness' of the transaction to the shareholder plaintiff.[430]

Therefore, in *Technicolor* the procedural aspect and the traditional safe harbor role of the business judgment rule have been eliminated.[431]

There have been many criticisms of *Technicolor*. Johnson considers that the court made some mistakes: it subsumed the duty of care ('a pervasive duty,' the standard of conduct) under the business judgment rule ('a specialized judicial review policy,' the standard of review)[432]; it also wrongfully associated the duty of care with the element of 'informedness' in the business judgment rule[433]; in addition, the application of the 'entire fairness' standard in a duty of care case was unprecedented.[434]

Bainbridge also raises several doubts about the approach of *Technicolor*.[435] Firstly, the business judgment rule loses its most important function under this approach. Under *Technicolor*, the plaintiff only needs to prove the defendant's

429 634 A.2d 345 (Delaware 1993). The case is followed by, for example, *Emerald Partners v. Berlin*, 726 A.2d 1215, (Delaware 1999), and *McMullin v. Beran*, 765 A.2d 910 (Delaware 2000), see Bainbridge (2004), at p. 94, Footnote 66.

430 634 A.2d 345, 361 (Delaware 1993).

431 Bainbridge (2004), p. 87.

432 Johnson (1999), p. 803.

433 Johnson (1999), p. 803.

434 Johnson (1999), p. 799.

435 Bainbridge (2004), at pp. 101-102.

breach of any aspect of the fiduciary duty. This burden of proof lies with the plaintiff in most civil litigations (except those of no-fault liability). Secondly, while under the traditional abstention approach the business judgment rule prevents the court from judging whether the director breached his duty of care, the approach of *Technicolor* may broaden the scope of judicial review and increase the risk of strike suits as well. Bainbridge compares the approach of *Technicolor* with the traditional one and concludes '*Technicolor*'s formulation suggests far less judicial deference to the board …'.[436] He also comments that:

> Notice how the court puts the cart before the horse. Directors who violate their duty of care do not get the protections of the business judgment rule; indeed, the rule is rebutted by a showing that the directors violated their fiduciary duty of 'due care.' This is exactly backwards. As we shall see, the abstention doctrine approach to the rule prevents plaintiff from litigation that very issue. Put another way, the whole point of the business judgment rule is to prevent courts from even asking the question: did the board breach its duty of care?[437]

Nevertheless, Veasey and Guglielmo consider that *Technicolor* may not make a big difference in practice due to the limitation of directors' personal liability for money damages to the corporation or its shareholders.[438] I will discuss this limitation in Section 3.4.5.1.

3.4.2 Procedural requirements on plaintiffs to bring derivative actions

3.4.2.1 The standing requirements

In order to bring a derivative action, the plaintiff must meet several standing requirements. Although specifically federal and state rules differ on the standing requirements, the most common requirements are as follows. First, the plaintiff must be a shareholder, either a record owner of shares or have some beneficial interest in an equity security, when the suit is brought. For this purpose, a shareholder of a parent company may also bring a derivative action on behalf of the subsidiary of the parent company. This is the so-called double derivative action. Second, the plaintiff must have been a shareholder at the time of the transaction of which he complains, or by operation of law acquired the shares from a former holder who owned the shares at the time of the transaction. This is the commonly referred to 'contemporaneous ownership' rule. Third, the plaintiff must continuously have been a shareholder at the time of the action and throughout the pendency of the action. This is referred to as the 'continuing ownership'

436 Bainbridge (2004), at p. 94.
437 Bainbridge (2004), at pp. 94-95.
438 Such as section 102(b)(7) of the DGCL (Westlaw: 8 Del. Code Ann. s 102(b)(7)). The facts of *Technicolor* happened in 1982-1983, before the enactment of section 102(b)(7) in 1986; see Veasey & Guglielmo (2005), p. 1428.

requirement. Fourth, the plaintiff must be able to represent fairly and adequately the interests of the shareholders.[439]

Since the requirements of 'contemporaneous ownership' and 'continuing ownership' generate more problems than do others, I will need to discuss them in detail in the following sections.

The contemporaneous ownership rule

The contemporaneous ownership rule is the most controversial of the above-mentioned standing requirements. The original purpose of the contemporaneous ownership rule was to prevent collusion in manipulating the case to create federal jurisdiction and, generally speaking, to engage in forum shopping.[440] This is still the major purpose of the rule under the Federal Rules of Civil Procedure.[441] Nevertheless, the focus of the rule nowadays, especially for state rules, is more on the prevention of unjust enrichment and the prevention of purchase of suits.[442]

The controversy surrounding the rule mainly lies in the fact that these purposes may not exactly explain why the rule is needed. In fact, in some quarters it is regarded that the real ground for the contemporaneous ownership rule may, to a greater extent, lie in a distasteful attitude towards derivative actions rather than the purposes of prevention of unjust enrichment and prevention of purchase of suits.[443] For example, if the prevention of purchase of suits is the real concern, the rule may be relaxed so that a shareholder who discovered the misconduct after he bought the shares will be allowed to bring a derivative action, even if he was not a shareholder at the time the misconduct was committed.[444]

The mere purpose of prevention of unjust enrichment may also change the rule. Actually, whether a person suffers losses through the misconduct against the corporation is not decided by the fact of whether or not he was a shareholder at the time the misconduct was committed; instead, it is actually decided by the price at which he bought or sold shares. For example, if he bought shares after the misconduct had been committed but before the misconduct was disclosed, he still paid the higher price as if there had been no wrongdoing. Therefore, in order to prevent unjust enrichment, it is better to lay down the standard that the plaintiff should have bought the shares before the misconduct was known instead of the standard of contemporaneous ownership. The ALI Principles actually suggest adopting the standard of having bought shares before the misconduct was known

439 As to the requirements, see, among others, ALI (II), Section 7.02; MBCA, s 7.41; Federal Rules of Civil Procedure, Rule 23.1; Cox & Hazen (2002), pp. 445-450; Ferrara et al. (2005), Section 4.02, etc.

440 *Hawes v. Oakland*, 104 U.S. 450 (1881); see also Ferrara et al. (2005), Section 4.02, [2].

441 Hamilton (2000), p. 544.

442 See, for example, ALI (II) Section 7.02, Comment C, p. 37, Hamilton (2000), pp. 543-544.

443 Hamilton (2000), p. 544.

444 Hamilton (2000), pp. 543-544.

and so they do depart from the contemporaneous ownership rule. The Principles propose in Section 7.02(a)(1) that in order to commence and maintain a derivative action, the shareholder should have acquired the shares 'before the material facts relating to the alleged wrong were publicly disclosed or were known by, or specifically communicated to, the holder.' California law also takes a similar approach to that of the ALI Principles.[445]

In fact, the purpose behind prevention of unjust enrichment itself is also doubted. Since recovery in a derivative action will go to the corporation, all current shareholders will benefit from the recovery, no matter when they became shareholders. Therefore, a windfall for some shareholders is unavoidable. In fact, the requirement that only injured shareholders are allowed to bring derivative actions is, to a greater extent, aimed at ensuring that plaintiffs have sufficient incentives to act in the best interests of the company, and at preventing speculation through litigations.[446] Prevention of unjust enrichment is only the *prima facie* purpose.[447] Besides, the justifications behind prevention of unjust enrichment is mainly based on the approach that derivative action plays a compensatory function. From the perspective of a deterrent function, these justifications may not be persuasive.[448] For example, if a derivative action is allowed even if the corporation did not suffer losses, the distinction between contemporaneous and non-contemporaneous ownership is meaningless as far as the prevention of unjust enrichment is concerned.[449]

Due to doubt over the contemporaneous ownership rule, Pennsylvania has taken a more liberal approach towards it. It allows a non-contemporaneous shareholder to bring a derivative action in order to avoid the injustice of a serious wrong to the corporation going unredressed.[450]

The contemporaneous ownership rule also has an exception that is known as the 'continuing wrong doctrine.' This exception indeed makes the contemporaneous ownership rule more complicated. Under the continuing wrong doctrine, a shareholder may bring a derivative action if the alleged wrong was still continuing at the time that he bought his shares, even if the wrong arose before that time. The continuing wrong doctrine properly acknowledges the fact that some wrongs to the corporation involve a series of transactions instead of a single one. When the wrong continues, the person who bought shares after the commencement of the

445 West's Ann. Cal. Corp. Code Ann. s 800(b)(1); also see Cox (1999), p. 39; ALI (II), Section 7.02, Comment C, p. 38.

446 Ferrara et al. (2005), Section 4.02, [2].

447 Cox (1999), p. 10, Footnote 18.

448 See, for example, Cox (1999), p. 39.

449 For example, see *Diamond v. Oreamuno*, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969); see Cox (1999), p. 10, Footnote 18.

450 Pa. Bus. Corp. Law s 1782(b) (Westlaw: 15 Pa.C.S.A. s 1782(b)); see Cox (1999), p. 39; ALI (II) Section 7.02, Comment C, p. 38.

wrong, but before its effect came into force, is also injured. The problem is, however, how to define 'continuing wrong.' Different standards have been applied.[451] Normally the mere fact that the effect of a wrong continues to harm is not enough.[452]

On the other hand, being afraid that the 'continuing wrong doctrine' might swallow the contemporaneous ownership doctrine, some courts, including the Second Circuit of the Federal Court, as well as some scholars, refuse to accept the continuing wrong doctrine.[453]

The continuing ownership rule

The continuing ownership rule requires that the plaintiff continue to hold shares in the corporation until the time of judgment.[454] The rule is aimed at avoiding abuse of derivative actions: since a former shareholder in the corporation cannot benefit from the derivative action under which, if successful, recovery will be awarded to the corporation, there is a higher risk for the plaintiff to abuse the action.[455] The rule is generally logical. Nevertheless, it may cause problems in special situations such as mergers. Therefore, some states have developed exceptions to the rule.[456] For example, Delaware courts generally recognize two exceptions: first, when the merger itself is for the purpose of depriving shareholders of the standing to sue or is the subject of a claim of fraud, a former shareholder may bring a derivative action; second, when shareholders receive different securities due to the merger but effectively remain the owners of the same business, they too can bring derivative actions.[457] The ALI Principles also recognize two exceptions. Section 7.02(a)(2) allows a former shareholder to commence a derivative action if his failure to own shares until the time of judgment is:

> … the result of corporate action in which the holder did not acquiesce, and either (A) the derivative action was commenced prior to the corporate action terminating the holder's status, or (B) the court finds that the holder is better able to represent the interests of the shareholders than any other holder who has brought suit.[458]

451 Ferrara et al. (2005), Section 4.02 [3] [b].
452 Ferrara et al. (2005), Section 4.02 [3] [b].
453 See, for example, *In re Bank of New York Derivative Litigation.*, 320 F.3d 291 (2d Cir. 2003); Robinson (2005).
454 See, for example, ALI (II) Section 7.02(a)(2).
455 ALI (II) Section 7.02, Comment D, pp. 38-39.
456 See ALI (II) Section 7.02, Reporter's Note 4, pp. 46-49.
457 ALI (II) Section 7.02, Reporter's Note 4, p. 47; Ferrara et al. (2005), Section 4.03.
458 ALI (II), Section 7.02(a)(2).

3.4.2.2 The demand requirement

3.4.2.2.1 Overview

The demand requirement is regarded as one of the most significant barriers under American law to shareholders' derivative actions.[459] This requirement, laid down even earlier than the important Supreme Court decision in *Hawes v. Oakland*[460], is regarded as being greatly influenced by, but having developed in a different way from the English *Foss v. Harbottle* rule.[461]

The purpose of the demand requirement is 'to permit the corporation to reconsider its decision not to assert a claim and to control the litigation with respect to the claim'.[462] Because the cause of action belongs to the corporation, a shareholder who intends to initiate a derivative action must first make a demand on the corporation to challenge the alleged misconduct. Generally, the board of directors is granted the power to execute business matters, including the decision to bring the corporate suit or not. Therefore, a demand must be made on the corporate board of directors. In addition, the shareholders collectively (the general meeting of shareholders) may also have the right to make a litigation decision for the corporation. Thus, a demand on shareholders collectively may also be needed. I will discuss the demand on the board and the demand on the shareholders in turn.

Since the Federal Rule of Civil Procedure 23.1 also provides for the demand requirement as state laws do, we should clarify the source for the law on the demand requirement in federal courts. In fact, federal courts when hearing derivative suits, which have arisen from diverse jurisdictions and are based on state law, must apply state law concerning the demand requirement. In addition, federal courts when hearing derivative claims based on violations of federal law must also apply state law concerning the demand requirement unless the state requirements conflict with policies underlying the federal law.[463] As a result, the Federal Rule of Civil Procedure 23.1 does not provide a substantive rule of law; it 'speaks only to the adequacy of the shareholder representative's pleadings'.[464]

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459 Ferrara et al. (2005), Section 1.06; Cox & Hazen (2002), p. 429.

460 The first case to lay down the demand requirement was the Massachusetts Supreme Court decision of *Brewer v. Proprietors of Boston Theatre*, 104 Mass. 378 (1870); see Section 3.1.1.2.1.

461 Boyle (1965), pp. 323-325.

462 Lockwood & Barsch (1996), p. 656.

463 *Kamen v. Kemper Fin. Servs.*, 111 S. Ct. 1711, 1716-1717 (1991). For a detailed discussion of the issue, see Ferrara et al. (2005), Section 3.05; DeMott (2003), Section 5:8.

464 *Kamen v. Kemper Fin. Servs.*, 111 S. Ct. 1711, 1716 (1991).

3.4.2.2.2 Demand on the board requirement

3.4.2.2.2.1 Overview

Rationale behind the demand on the board requirement[465] *(purposes of the demand requirement)*

The demand requirement gives the board the opportunity to consider the disputes before the individual shareholder brings the issue before the court. It reflects the basic principle of corporate law, which is that the power to manage corporate business, including the power to make a litigation decision, is granted to the board of directors rather than to individual shareholders. It also reflects the consideration that the board is normally more competent than an individual shareholder to make a litigation decision for the corporation. Furthermore, the demand requirement also functions as a support for judicial economy. The requirement may encourage intra-corporate dispute solutions and thus avoid unnecessary suits. In fact, courts normally will not interfere in internal business matters unless all intra-corporate remedies have been exhausted.[466] Finally, by acknowledging the board's power to dismiss a shareholder's derivative action, the demand requirement also discourages any shareholder's strike suits and protects the directors from unjust harassment, provided the board exercises its power in the right way.

Major issues around the demand on the board requirement

The requirement to make a demand on the board raises many theoretical and practical issues. Among them two basic and important issues attract much attention. Firstly, can the demand be excused in special situations and, if yes, under what circumstances? Secondly, what is the effect of the board's decision? If the board's decision is not decisive, what kind of standard will the court apply when it reviews the board's decision, especially the decision to dismiss a derivative action? These two issues are interrelated. For example, the standard of judicial review may differ in the demand-required and demand-excused cases. In the following sections I will discuss the issues in turn.

3.4.2.2.2.2 Recognition of the demand futility exception or not

3.4.2.2.2.2.1 Recognition of the demand futility exception (the distinction between the demand-required and demand-excused cases)

Most states will excuse demand in certain situations. For example, where the majority of the board is involved in the alleged misconduct or is controlled by the

465 For a detailed introduction of the rationale, see, for example, Ferrara et al. (2005), Section 3.02; Clark R. C. (1986), Section 15.2, p. 641.

466 Ferrara et al. (2005), Section 3.02, text accompanying Footnote 2.

wrongdoer and therefore could not make a sound litigation decision, it would be futile for the plaintiff shareholder to make a demand on the board. Therefore, in order to avoid fruitless behavior[467], these states normally will excuse demand if the shareholder can establish that a demand on the board would be futile.

The standards for determining futility vary widely in different states. In Delaware, which has the most developed law in terms of standards for the demand futility cases, a two-pronged standard has been established.[468] In order to satisfy demand futility, the plaintiff shareholder must establish that:

> (1) whether threshold presumption of director disinterest or independence are rebutted by well-pleaded facts; and, if not, (2) whether the complaint pleads particularized facts sufficient to create a reasonable doubt that the challenged transaction was the product of a valid exercise of business judgment [by the board].[469]

Nevertheless, where the case involves a board's alleged failure to take action, the second prong will be inapplicable since no business judgment has been made by the board; therefore only the first prong will apply.[470]

Although states differ on the standards applied to decide demand futility, most of them, as well as the Federal Rules of Civil Procedure, require that the plaintiff pleading demand futility must plead with particularized facts that the standards have been met.[471] For example, the mere fact that the directors were nominated or elected by the defendant, or mere proof of a majority ownership by the defendant, or the mere allegation that the majority of the board approved of or acquiesced to the challenged transaction is insufficient to render a demand futile.[472] This requirement to plead with particularity indeed puts a significant burden on the plaintiff, especially considering the fact that normally the plaintiff is not allowed discovery at this stage.[473]

If the plaintiff shareholder cannot demonstrate successfully that a pre-suit demand would be futile, he must take his demand to the board. The distinction between demand-required and demand-excused cases may not only be procedural but may also have a substantive effect. For example, in Delaware if the plaintiff shareholder pleads a demand on the board, the demand pleaded necessarily suggests that there are no situations of 'demand futility' such as the existence of the majority directors' interestedness or independence. In other words, the

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467 Swanson (1993), p. 1351, Footnote 71.

468 Ferrara et al. (2005), Section 6.03[1].

469 *Levine v. Smith*, 591 A.2d 194, 207 (Delaware 1991). The first Delaware case to initiate the two-pronged test was *Aronson v. Lewis*, 473 A.2d 805, 815 (Delaware 1984).

470 *Rales v. Blasband*, 634 A.2d 927, 933-934 (Delaware 1993).

471 Ferrara et al. (2005), Section 6.02.

472 *Aronson v. Lewis*, 473 A.2d 805, 814-815 (Delaware 1984).

473 Swanson (1993), pp. 1376-1377.

plaintiff cannot later claim these situations in order to prove the board's 'wrongful refusal' of the demand.[474] In addition, under Delaware law, whether the case is a demand-required one or a demand-excused one may well decide the outcome of the case because the standard of judicial review of the board's decision will be different in both cases.[475] Therefore, it is not surprising that shareholders will always plead demand futility under Delaware law.[476] However, if later the court decides in this case that a demand is required, the plaintiff cannot change his position and make such a demand, rather, the case is simply over.[477] In fact, the Delaware law on demand is regarded as 'being extremely favorable to defendants'.[478]

3.4.2.2.2.2.2 A universal demand requirement

Recognition of the demand futility exception may generate the problem of collateral litigation. Because there is no clear and consistent standard for deciding demand futility, and because the distinction of demand-required and demand-excused cases has significant substantive and procedural effects on the outcome of the derivative action, a collateral suit in addition to the derivative action may be initiated to identify whether the case is demand-excused or not. In fact, this has generated 'a considerable amount of litigation, with inconsistent and confusing results'.[479]

Partly due to this problem that is intrinsic in the demand required/demand excused distinction, there has been a trend toward abolishing the distinction and accepting a universal demand requirement.[480] According to the universal demand requirement, a demand on the board would be required in all cases except where such a demand would result in irreparable injury to the corporation.[481] This universal demand requirement was first adopted in the MBCA in 1989 and has been subsequently followed in some states.[482] The ALI Principles also take this approach.[483] The Pennsylvanian Supreme Court adopted this approach as its first supporting judicial decision.[484]

It is thought that a universal demand requirement might reduce the problem of collateral litigation, which arises when distinguishing between demand-required

474 Singhof & Seiler (1998), pp. 547-548; Swanson (1993), p. 1349.

475 As to the different standards of judicial review, please see Section 3.4.2.2.2.3.

476 Hamilton (2000), p. 551.

477 Hamilton (2000), p. 552.

478 Hamilton (2000), p. 552.

479 Ferrara et al. (2005), Section 6.03.

480 ALI (II) Section 7.03(b), Comment E, p. 57; Ferrara et al. (2005), Sections 3.01, 6.03.

481 See, for example, MBCA, s7.42(2). But according to the ALI, even in such cases, demand should be made promptly after commencement of the action, see ALI (II) Section 7.03(b).

482 MBCA, section 7.42. States adopting this approach include Florida, Georgia, Michigan, Virginia, Wisconsin, New Hampshire, Arizona, Connecticut, Idaho, Maine, Mississippi, Montana, Nebraska, North Carolina, Texas, and Wyoming; see Ferrara et al. (2005), Section 3.01, Footnote 9; DeMott (2003), Section 5:9, pp. 5-33 – 5-34.

483 ALI (II) Section 7.03(b).

484 *Cuker v. Mikalauskas*, 692 A.2d 1042 (Pa. 1997); Ferrara et al. (2005), Section 3.07.

and demand-excused cases.[485] In addition, there are other arguments for the universal demand requirement. For example, it is said that the universal demand requirement would promote efficiency: elimination of pre-suit litigation to decide whether the demand is futile or not will save on these costs, which would exceed the costs of making a demand.[486] The universal demand requirement also forcefully draws the board's attention to the plaintiff's claim and so may promote alternative dispute resolutions.[487] Finally, as compared to Delaware's dual standards for judicial review of the board's decision, which is based on the demand-required and demand-excused distinction, a universal demand requirement is regarded as offering a clearer and simpler standard.[488]

Nevertheless, there have also been doubts about the approach of a universal demand requirement. The most famous objections were made by the Supreme Court in *Kamen v. Kemper Financial Services, Inc.*[489] The Court held that a universal demand requirement would make any corporate decision uncertain and less predictable.[490] In addition, the advantage of eliminating collateral litigation was also brought into doubt since the universal demand 'will merely shift the focus of threshold litigation from the question whether demand is excused to the question whether the directors' decision to terminate the suit is entitled to deference under federal standards'.[491] Finally, the court did not agree that the universal demand requirement provided an effective alternative approach to dispute resolution.[492]

Due to these controversies, although many states have adopted the universal demand requirement, it is still unclear whether it will replace the traditional approach of allowing the demand-excused exception in certain situations.[493]

3.4.2.2.2.3 The effect of litigation decisions of the board or a litigation committee (the standard of judicial review)

3.4.2.2.2.3.1 Overview

In demand-required cases, plaintiff shareholders must make a demand on the board before initiating a derivative action. The board must respond within a reasonable time; otherwise, the demand is deemed satisfied.[494] The board may

485 ALI (II) Section 7.03(b), Comment E, p. 57.

486 ALI (II) Section 7.03(b), Comment E, pp. 57-58; MBCA Ann. S7.42, Official Comment at 7-342 (3d ed.); see Ferrara et al. (2005), Section 3.07.

487 ALI (II) Section 7.03(b), Comment E, p. 57; MBCA Ann. S7.42, Official Comment at 7-342 (3d ed.); see Ferrara et al. (2005), Section 3.07.

488 ALI (II) Section 7.03(b), Comment E, p. 58.

489 500 U.S. 90, 111 S.Ct 1711, 114 L.Ed.2d 152 (1991).

490 500 U.S. 90, 104 (1991).

491 500 U.S. 90, 104 (1991).

492 500 U.S. 90, 106 (1991).

493 Ferrara et al. (2005), Section 6.03.

494 Cox & Hazen (2002), p. 430.

undertake investigations as necessary and make decisions by itself. It may also appoint a committee or others to do the investigation and make decisions by themselves based on this investigation. Or it may even delegate full authority to a special litigation committee to respond to the demand even in demand-required cases. Full delegation of authority to a special litigation committee does not necessarily concede that the board is lacking in independence with respect to the demand, which would thus make the demand futile.[495]

There are several ways the board may respond to the demand. The board may, although rarely, agree to initiate an action against the alleged misconduct in the name of the corporation. In such cases, a derivative action is no longer necessary; the board will bring the action in the name and on behalf of the corporation.[496] Similarly, the board may take measures other than litigation to address the problems raised by the shareholder. The board may also claim that the shareholder's demand was inadequate. However, in most cases, the board will take a negative attitude toward the shareholder's proper demand. The board will decide not to sue in the name of the corporation and seek for dismissal of the shareholder's derivative action if it has been initiated. Therefore, since the shareholder and the board take different attitudes, the following problem will arise: Does the board's decision not to sue have a binding effect? Or, in other words, can the shareholder have any basis for challenging the board's decision and to what extent should the court defer to the board's decision? I will discuss these problems in Section 3.4.2.2.2.3.2.

Shareholders may also bring a derivative action without making a pre-suit demand by alleging that the demand should be excused based on demand futility exceptions. Until recently, if the shareholder had successfully pleaded the excuse of a demand, the board played no role in deciding whether the litigation should be pursued and the derivative action maintained[497] since obviously an interested or a dependent board would only make a decision not to sue and such a decision would carry no weight. However, since the mid-1970s, courts have begun to recognize that a special litigation committee appointed by the board of directors might make a litigation decision for the corporation. Questions surrounding the special litigation committee have arisen, such as the qualifications of the committee and the standard of judicial review of the committee's decisions. I will discuss these issues in Section 3.4.2.2.2.3.3.

Where the distinction between demand-required and demand-excused cases is recognized, most states acknowledge that different standards of judicial review of the board's or the committee's decisions will be applied.[498] However, where a

495 Ferrara et al. (2005), Section 7.07.

496 Ferrara et al. (2005), Section 7.02; DeMott (2003), Section 5:10, p. 5-41.

497 Ferrara et al. (2005), Section 8.01.

498 See Sections 3.4.2.2.2.3.2 and 3.4.2.2.2.3.3.

universal demand requirement is needed, what should the standard be? I will discuss the issue in Section 3.4.2.2.2.3.4.

3.4.2.2.2.3.2 The standard of judicial review in demand-required cases

If the board refuses to sue after the complaining shareholder has made a proper demand on it or if it seeks for dismissal of the derivative action initiated, the plaintiff cannot challenge the board's refusal or dismissal unless the refusal or dismissal is wrong.[499] This is the so-called 'wrongful refusal' rule.[500] The judicial deference to the board's decision has some justifications. First, as mentioned, a corporate litigation decision is a business decision and is left to the discretion of the board of directors. The board can decide whether to sue based on several factors, such as the cause of action, the cost and the benefit the action will bring to the corporation.[501] If the action is not in the best interests of the corporation, the board may decide not to sue. Like normal business decisions, the board's litigation decision also falls within the scope of the business judgment rule.[502] Second, this judicial deference is also a natural consequence of the demand requirement.[503] If the board's negative response to the demand is not respected by the court, the demand requirement would become meaningless and just be 'an empty formality'.[504]

However, this in no way means that the court should defer to all the board's decisions. The court will apply its own standard to decide to what extent it will defer to the board's decision. In demand-required cases, the court normally will apply the business judgment rule to decide whether the decision should be deferred to or not.[505] In other words, in order to set aside the board's negative litigation decision, the plaintiff shareholder must allege a reasonable doubt that a majority of the board was in fact disinterested or independent, or that it acted in good faith and with due care, or that it rationally believed the decision was in the best interests of the corporation.[506] The plaintiff must allege his complaint with particularity; conclusory allegations alone are not sufficient.[507]

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499 For example, *Levine v. Smith*, 591 A.2d 194 (Delaware 1991).

500 Ferrara et al. (2005), Section 7.02.

501 Cox & Hazen (2002), p. 429; Ferrara et al. (2005), Section 7.08.

502 See, for example, *Joy v. North*, 692 F.2d 880, 887 (2d Cir. 1982); *Burks v. Lasker*, 441 U.S. 471, 487, 99 S.Ct. 1831, 60 L.Ed.2d 404 (1979); *United Copper Securities Co. v. Amalgamated Copper Co.*, 244 U.S. 261, 263-264, 37 S.Ct. 509, 61 L.Ed. 1119 (1917). Also see Ferrara et al. (2005), Section 5.04; Cox & Hazen (2002), p. 429.

503 Ferrara et al. (2005), Section 7.02.

504 *Spiegel v. Buntrock*, 571 A.2d 767, 777 (Delaware 1990); also see Ferrara et al. (2005), Section 7.02, Footnote 8.

505 For example, *Aronson v. Lewis*, 473 A.2d 805, 813 (1984); also see Ferrara et al. (2005), Section 7.02, Footnote 5.

506 See, for example, *Levine v. Smith*, 591 A.2d 194 (Delaware 1991); also see Ferrara et al. (2005), Section 7.02.

507 See, for example, *Levine v. Smith*, 591 A.2d 194 (Delaware 1991); also see Ferrara et al. (2005), Section 7.02.

The application of the business judgment rule to the board's refusal of the demand may, nevertheless, impose too much of a burden of proof on the plaintiff shareholder, especially in view of the fact that in Delaware, for example, discovery is not available to the plaintiff and, therefore, it is difficult for the plaintiff to acquire the necessary evidence.[508] Nevertheless, this burden may well be reduced by the recent development in Delaware law, which encourages the plaintiff to use section 220 of the DGCL to improve his pleading.[509] New Jersey went further to ease the plaintiff's burden by adopting a modified business judgment rule. Where a board has refused to sue after a demand has been made on it, the board bears the burden of proving that it was disinterested and independent, that its decision was made in good faith and with due care, and that the decision was reasonable.[510] The New Jersey Supreme Court also held that the parties were entitled to discovery before the court made its decision.[511]

Another aspect of Delaware law may make it more difficult to challenge the board's refusal of the demand in Delaware. According to Delaware law the plaintiff shareholder, by making a demand on the board, concedes that a majority of the board was independent; therefore, he can only challenge the board's refusal by alleging that the board was lacking in good faith or due care.[512] On the other hand, the board's delegation of its power to make a decision to a special litigation committee does not necessarily concede that the board was interested or dependent.[513]

3.4.2.2.2.3.3 The standards of judicial review in demand-excused cases: the special litigation committee

3.4.2.2.2.3.3.1 The increasing role of the special litigation committee

As mentioned, until recently, if the plaintiff shareholder successfully pleaded demand futility, the board, which was generally interested in the transaction or was controlled by the wrongdoers, was regarded as not the appropriate body to make a fair litigation decision for the corporation. Therefore, the plaintiff was free to initiate a derivative action. However, this approach has been changed. Since the mid-1970s an independent body within the corporation, the special litigation committee, has been regarded in most states as being competent and appropriate for making a litigation decision for the corporation.[514] Hence, if the special litigation committee decides in the best interests of the corporation not to

508 DeMott (2003), Section 5.11, p. 5-48; Ferrara et al. (2005), Section 7.03.

509 For a discussion of the application of Section 220 in derivative action cases, see Section 3.4.6.

510 *In re PSE & G Shareholder Litigation*, 173 N.J. 258, 286, 801 A.2d 295, 312 (2002); DeMott (2003), Section 5.11, p. 5-49; Ferrara et al. (2005), Section 7.04.

511 *In re PSE & G Shareholder Litigation*, 173 N.J. 258, 288, 801 A.2d 295, 313 (2002); DeMott (2003), Section 5.11, p. 5-49; Ferrara et al. (2005), Section 7.04.

512 DeMott (2003), Sections 7.05, 7.06.

513 Ferrara et al. (2005), Section 7.07.

514 DeMott (2003), Section 5.14, p. 5-90; Ferrara et al. (2005), Section 8.01.

sue, such a decision may, under certain conditions, have a binding effect and then bar any derivative action initiated by the shareholder. The fact is that the special litigation committee is regarded as a recently developed mechanism that has a substantial negative effect on the function of derivative actions.[515]

A special litigation committee is comprised of independent directors who were appointed by the board of directors for the purpose of deciding whether the corporation should seek dismissal of a derivative action, which will affect a majority of the board of directors.[516] In order to be capable of making this decision in the best interests of the corporation, the committee must be given full authority to make that decision and must be disinterested or independent.[517]

3.4.2.2.2.3.3.2 The standards of judicial review of the special litigation committee's decision

Overview

There is an argument that the board's litigation decision differs from its normal business judgment in certain aspects and should not be accorded the same degree of judicial deference as a normal business judgment. Therefore, the normal business judgment rule may be inappropriate for reviewing the board's litigation decision.[518] There are several reasons in support of this argument.[519] First, unlike investment decisions, directors are normally under less pressure to make litigaion decisions and face less uncertainty. Second, directors are unlikely to be liable for their decision not to sue since such a decision generally will not cause damage to the corporation. Therefore, the rationale under the business judgment rule for encouraging business risk-taking is not applicable in making litigation decisions. Third, the rationale under the business judgment rule that judges are not business experts and should not take advantage of *ex post* judgment may not apply to litigation decisions because litigation decisions obviously involve issues such as merits of the action, which the court is more capable of considering than directors are, and because litigation decisions are normally retrospective rather than predictive.

However, as mentioned in Section 3.4.2.2.2.3.2, in demand-required cases where the action is normally against a third party and the board is disinterested and independent, the argument mentioned above is not paid attention to and courts generally still apply the business judgment rule to review the board's litigation decision.

515 See, for example, Coffee & Schwartz (1981), p. 262.
516 Ferrara et al. (2005), Section 8.01.
517 DeMott (2003), Section 5.23.
518 Coffee & Schwartz (1981), pp. 280-284; Cox & Hazen (2002), pp. 429-430.
519 For a detailed discussion of the reasons, see Coffee & Schwartz (1981), pp. 280-284; Cox & Hazen (2002), pp. 429-430.

It may be different for those cases where a majority of the board has an interest in the challenged transaction or is controlled by the wrongdoer. In such cases a demand on the board may then be excused but a special litigation committee is authorized by the board to make the litigation decision against the transaction. It is argued that the business judgment rule may not be applicable to a review of the committee's decision. The most important concern, besides the reasons mentioned above, is the 'structural bias' problem. Since the committee members are normally appointed by the 'tainted' board and work closely with the directors charged, they tend to perceive their role 'as that of a buffer by which to shelter and protect management from hostile and litigious stockholders'.[520] 'In particular, a derivative action evokes a response of group loyalty, so that even a "maverick" director may feel compelled to close ranks and protect his fellows from the attack of the "strike suiter"'.[521] Therefore, the committee members, when making the litigation decision, may act with a 'there but for the grace of God go I' attitude and show sympathy for their colleagues.[522] The fact that in practice in a substantial number of cases the special litigation committee has recommended not suing their colleague directors may support the likelihood of the 'structural bias' problem.[523]

Of course, the likelihood of the structural bias problem and its influence on the special litigation committee's decision should be identified on a case-by-case basis. Nevertheless, a relevant issue is what standard the court should apply when it reviews the special litigation committee's decision not to sue. Should the court take a stricter approach than the business judgment rule, taking into consideration the likelihood of structural bias? Or should the court simply stick to the business judgment rule? The answer to this issue directly affects the function of the special litigation committee in derivative actions and therefore the function of derivative actions as well: a stricter standard of judicial review may to a greater extent invalidate the committee's decision not to sue and give shareholders more chances to bring derivative actions, and *vice versa*. In the United States, this is an issue of state law unless a federal policy would be frustrated.[524] In reality, jurisdictions have differed widely on this issue. There are three basic approaches that I will discuss in the sections to follow.

The New York Rule

The New York Court of Appeal's decision in *Auerbach v. Bennett* in 1979 was one of the first state court-of-last-resort decisions to deal with the issue of the standard of judicial review of a special litigation committee's decision in demand-

520 Coffee & Schwartz (1981), p. 283.
521 Coffee & Schwartz (1981), p. 283.
522 *Zapata Corpl v. Maldonado*, 430 A.2d 779, 787 (Delaware 1981).
523 Ferrara et al. (2005), Section 8.01, text accompanying Footnote 7.
524 *Burks v. Lasker*, 441 U.S. 471, 60 L. Ed. 2d 404, 99 S Ct 1831 (1979).

excused cases.[525] In this case, the court held that the business judgment rule would protect the substance of the special litigation committee's decision from judicial review. Recognizing that the committee's decision had two aspects, the process by which the decision was made and the substance of the decision itself, the court would only review the process as well as the independence of the committee, and not the substance of the decision. Therefore, *Auerbach* also followed the standard of the business judgment rule for reviewing the special litigation committee's decision in demand-excused cases, the same standard as that in demand-required cases, and thus rejected the claim that the special litigation committee was tainted by structural bias.[526] The case has been followed in New York as well as in some other states.[527]

Nevertheless, the *Auerbach* approach has been criticized for giving too much deference to the special litigation committee's decision.[528] It is argued that where a majority of the board is not sufficiently disinterested when making a litigation decision, more judicial scrutiny should be applied to review the committee's decision not to sue on the grounds of protecting the interests of the corporation and shareholders.[529]

The Iowa Rule

The Iowa Supreme Court took the opposite approach to that of the New York rule. In *Miller v. Register & Tribune Syndicate, Inc.*[530], it held that under no circumstances should the special litigation committee's decision not to sue be deferred to because, where the majority of the board was incapable of making a litigation decision, it had no authority to delegate such a power to a special litigation committee. This 'prophylactic rule' of the Iowa court in fact reflects the court's strong suspicion concerning the director's structural bias.[531]

The Delaware Rule

Most states actually take a position between New York and Iowa. They acknowledge that the special litigation committee's decision deserves a certain degree of deference, but adopt a stricter standard of judicial review of the decision than the New York standard of the business judgment rule. Therefore, the standard applied in these demand-excused cases should be different from the standard applied in the demand-required cases. Nevertheless, the specific standard of review varies in these states. I will discuss the Delaware rule here as a case in point.

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525 Ferrara et al. (2005), Section 8.02; DeMott (2003), Section 5.15, p. 5-91.
526 Matejka (1982), p. 1201.
527 Ferrara et al. (2005), Section 8.02.
528 Ferrara et al. (2005), Section 8.02, text accompany Footnote 19.
529 Ferrara et al. (2005), Section 8.02.
530 336 N.W.2d 709 (Iowa 1983).
531 Ferrara et al. (2005), Section 8.02; DeMott (2003), Section 5:16, p. 5-95.

The Delaware standard is well illustrated by the famous case of *Zapata Corp. v. Maldonado*.[532] In *Zapata*, the Delaware Supreme Court articulated a two-step test to review a special litigation committee's decision. First, the court must 'inquire into the independence and good faith of the committee and the bases supporting its conclusions'.[533] Unlike the application of the business judgment rule, here the corporation should 'have the burden of proving independence, good faith and a reasonable investigation'; independence, good faith and reasonableness should not be presumed.[534] Courts may at their discretion allow limited discovery.[535] Second, even if the corporation meets the burden of the first-step test, the court can still determine through 'its own business judgment' whether to dismiss the suit.[536] When applying its own business judgment, the court should give 'special consideration to matters of law and public policy in addition to the corporation's best interest'.[537]

The *Zapata* approach reflects the court's effort to strike a balance between the protection of the director's management and the interests of the corporation and shareholders. Recognizing the structural bias problem, the court realized that a business judgment rule was not sufficient to guard against a director's misconduct. Indeed, the court regarded the second step as 'the essential key in striking the balance between legitimate corporate claims as expressed in a derivative stockholder suit and a corporation's best interests as expressed by an independent investigating committee'.[538]

Nevertheless, the Delaware rule has also been criticized. The criticisms include, for example, that the application of the court's own business judgment may threaten traditional policies under the business judgment rule.[539] The different standards applied to demand-required and demand-excused cases may make a pre-suit trial unavoidable.[540] The linkage between the standards of judicial review and the demand-required/demand-excused distinction is regarded as unfortunate since the two issues are 'logically distinct and should be governed by different criteria'.[541] The court may also have to determine 'whether the action should proceed before the board or committee has had an adequate opportunity to conduct a review and evaluation' of the derivative action.[542]

532 430 A.2d 779 (Delaware 1981).
533 430 A.2d 779, 788 (Delaware 1981).
534 430 A.2d 779, 788 (Delaware 1981).
535 430 A.2d 779, 788 (Delaware 1981).
536 430 A.2d 779, 789 (Delaware 1981).
537 430 A.2d 779, 789 (Delaware 1981).
538 430 A.2d 779, 789 (Delaware 1981).
539 Ferrara et al. (2005), Section 8.03.
540 ALI (II) Section 7.03(b), Comment E, p. 58.
541 ALI (II) Section 7.03(b), Comment E, p. 58.
542 ALI (II), Section 7.10, Comment C, p. 134.

Conclusion

In conclusion, although the standard of judicial review of the special litigation committee's decision varies significantly in various states, the difference mainly exists as far as the review of the substance of the decision is concerned. It is generally recognized that the procedure by which the decision was made should be subject to judicial review. In other words, the independence, good faith and due care of the special litigation committee should be subjected to judicial review.

3.4.2.2.2.3.4 The standards of judicial review in universal demand cases

As mentioned, some states as well as the MBCA and the ALI Principles take the approach of a universal demand requirement. Nevertheless, they also follow different standards for judicial review of the board or the special litigation committee's decision.

MBCA

MBCA Section 7.44(a) states that:

> A derivative proceeding shall be dismissed by the court on motion by the corporation if one of the groups specified in subsections (b) or (f) has determined in good faith after conducting a reasonable inquiry upon which its conclusions are based that the maintenance of the derivative proceeding is not in the best interests of the corporation.

Therefore, the board or the special litigation committee's decision, if made in good faith and with due care, will be respected by the court. Nevertheless, unlike the business judgment rule, the MBCA shifts the burden of proof that the above conditions have been met from the plaintiff to the corporation 'if a majority of the board of directors does not consist of independent directors at the time the determination is made'.[543] If a majority of the board of directors consists of independent directors, the plaintiff still bears the burden of proving that the requirements have not been met in order to bring a derivative action.[544] The burden of proving the board's dependency lies with the plaintiff shareholder.[545] In conclusion, the MBCA applies the same standard of review to all board or committee decisions, but distinguishes the burden of proof according to the dependency of the majority of the board.

By shifting the burden of proof to the corporation, where a majority of the board is not independent, the MBCA takes a more shareholder-favoring approach than the business judgment rule. Nevertheless, this limited progress, along with the shareholder's initial burden of proving the board's dependency, is regarded as

543 MBCA, S7.44 (e).
544 MBCA, S7.44 (e).
545 MBCA, S7.44 Official Comment at 207; as cited in Swanson (1993), p. 1369.

restricting judicial inquiry too greatly and limiting a shareholder's right to derivative actions.[546]

ALI Principles

The approach taken by the ALI Principles has several characteristics. First, it recommends that the standard of judicial review of the board or of the committee's decision be linked to the defendant's identities. If the defendant is a third party rather than corporate insiders, specifically directors, senior executives or persons in control of the corporation, the business judgment rule should apply. While if the defendant is an insider (for the sake of simplicity, hereinafter referred to as directors), a bifurcated standard, as discussed below, should apply.[547]

The second and the more important characteristic is the recommendation that the standard of judicial review be linked to the nature of the claim. First of all, the court shall consider whether the 'dismissal would permit a defendant, or an associate … to retain a significant improper benefit'; if the plaintiff can establish that, the court shall not dismiss the action in certain circumstances.[548] If there is no retention of significant improper benefit, the standard is twofold: if the claim is against the director's violation of duty of care, the business judgment rule should apply. On the other hand, if the claim is against the director's violation of duty of loyalty, a closer judicial scrutiny should apply. This standard should encompass whether 'the board or committee was adequately informed under the circumstances and reasonably determined that dismissal was in the best interests of the corporation, based on the grounds that the court deems to warrant reliance'.[549] This dual standard is intended to strike a balance between 'the need for judicial review and the danger of litigation that it is contrary to the corporation's best interests to pursue'.[550] The more lenient approach to standards with regard to the claim against directors' duty of care is based, at least partly, on the ALI's conclusion that historically the derivative action plays a less important role in enforcing the duty of care than it does the duty of fair dealing.[551] It is said that 'S 7.10 rests on the judgment that the more important role of the derivative action has been to police unfair self-dealing, not unwise business decisions'.[552]

Although the ALI criticizes the Delaware approach of linking the standard of judicial review to the demand-required/demand-excused distinction, which is a 'structural test' mainly based on whether a majority of the board is 'interested' or

546 Swanson (1993), pp. 1369-1370.
547 ALI (II), Section 7.07.
548 ALI (II), Section 7.10(b).
549 ALI (II), Section 7.10(a).
550 ALI (II), Section 7.10, Comment C, p.133.
551 ALI (II), Section 7.10, Comment C, pp.133-135.
552 ALI (II), Section 7.10, Comment C, p.135.

not[553], the ALI does seem to agree with the Delaware law that a higher standard of judicial scrutiny should be applied to cases where it is doubtful whether the board can fulfill its duty of loyalty.[554]

The ALI's approach also has its disadvantages. The nature of the claim, that is, whether the misconduct is a breach of duty of care or of duty of loyalty, is not as easy to distinguish as it seems. Furthermore, the board may try to protect itself by arguing that the wrong is a breach of duty of care rather than a breach of duty of loyalty.[555]

3.4.2.2.2.3.5 Conclusion

In conclusion, in the United States there are no set standards of judicial review for the board or committee decision to dismiss a derivative action. More especially, the controversy lies within those cases where a majority of the board is incapable of making a right decision for the corporation and therefore the device of a special litigation committee is used. The great differences among various states as well as the MBCA and the ALI Principles make it difficult to predict the trend of development in this area[556], although the issue of the standard is pivotal to the function of derivative actions.

3.4.2.2.3 Demand on the shareholders

In addition to the requirement of making a demand on the board of directors, a minority of states requires that the plaintiff shareholder either make a demand on the other shareholders before initiating a derivative action or give an adequate reason for not doing so.[557] The policies underlying this requirement are almost the same as those underlying the demand on the board requirement.[558] First, a plaintiff shareholder should exhaust intra-corporate remedies before initiating a derivative action; where the board is not capable of making a litigation decision for the corporation, shareholders as a group should have such a power. Second, through such a demand shareholders may be given the opportunity to ratify the misconduct and therefore a derivative action would not be necessary anymore. Third, such a demand requirement may deter vexatious litigation.

However, there have also been arguments against the demand on shareholders requirement.[559] First of all, making a demand on shareholders normally costs a

553 ALI (II), Section 7.10, Comment C, pp.134-135.

554 Ferrara et al. (2005), Section 8.11.

555 Ferrara et al. (2005), Section 8.11.

556 DeMott (2003), Section 5:16, pp. 5-100 – 5-101.

557 For example, Hamilton (2000), p. 545.

558 For a detailed discussion of the policies, see, for example, Clark R. C. (1986) p. 650; Ferrara et al. (2005), Section 3.04.

559 For example, Clark R. C. (1986), p. 649; Ferrara et al. (2005), Section 3.04; Cox & Hazen (2002), pp. 426-427.

great deal of time and money, especially in public corporations; therefore it will place an extra burden on the plaintiff shareholders and may delay a derivative action. Second, since in public corporations shareholders normally do not participate in corporate management, they are not an appropriate body for making litigation decisions for the corporation. Third, most of the misconduct challenged by derivative actions cannot be ratified by a majority of shareholders. Fourthly, as far as deterring vexatious derivative litigation is concerned, a demand on directors is generally regarded as sufficient. Although some of the arguments are based on those situations found in public corporations, courts have not made a distinction between public and private corporations in any clear-cut way with regard to the requirement.[560]

Nowadays, the prevailing approach is to abolish the demand on shareholders requirement. Some influential states such as Delaware and New York, as well as the MBCA and the ALI Principles, have either explicitly abolished the requirement[561] or omitted any reference to such a requirement by simply referring to making a demand 'upon the corporation'.[562]

Even in those states where a demand on the shareholders is required, a number of grounds have been accepted to excuse the demand. In fact, recent cases have shown that the requirement has hardly ever been required in practice.[563] Although the specific grounds for excusing the demand vary from state to state, the most common grounds are: (1) where the misconduct complained of cannot be ratified by the shareholders so that it is useless to make a demand; (2) where a majority of the shareholders are interested in the misconduct so that a demand would be futile; and (3) where the number of the shareholders is so large that making a demand would be unreasonably costly and burdensome.[564]

3.4.2.2.4 Conclusion

To summarize, the demand requirement plays an important role in restricting the individual shareholder's right to derivative actions. The demand requirement may make it difficult for a plaintiff shareholder to initiate derivative actions from several perspectives, such as limited scope of demand-excused exceptions, role of the special litigation committee, loose approach of judicial review, and the plaintiff's burden of proof.

560 Clark R. C. (1986), p. 649.

561 Del Ch R 13.1; N.Y. Bus Corp L s 626(c) (Westlaw: McKinney's Business Corporation Law s 626(c)); ALI (II) Section 7.03; also see DeMott (2003), Section 5.2, pp. 5-3 – 5-4, Footnote 1.

562 MBCA s7.42.The official comment on the section states that the appropriate organ for reviewing the demand is in most cases the board of directors, and in occasional cases the officers. It does not mention the shareholders. See DeMott (2003), Section 5.2, p. 5-4, Footnote 2.

563 DeMott (2003), Section 5.2, p. 5-4.

564 Ferrara et al. (2005), Section 3.04; Hamilton (2000), 545.

3.4.2.3 Security-for-expenses provided by plaintiffs

As mentioned in Section 3.1.1.3, the mechanism of the security-for-expenses statute has been introduced since the 1940s in sixteen states, including New York, in order to deter abusive use of derivative actions. According to the security-for-expenses statute, derivative action plaintiffs, when holding less than the statutorily required minimum interest in the corporation, can be required by the corporation at any stage to post security for reasonable expenses. The statutes vary on the minimum interest; typically, a holding of five percent of the shares or a holding of shares exceeding an aggregate market value such as $50,000 is required.[565] As to the amount of the security, normally the plaintiffs will be required to post security for reasonable expenses which may be incurred by the corporation and by other defendants for which the corporation may become liable because of indemnification or otherwise with regard to the litigation, including attorney's fees in some states.[566] It is common for this amount to run into hundreds of thousands of dollars.[567] The security-for-expenses statute has another deterrent effect on the shareholders since, when being applied, it requires the plaintiff shareholders to pay the expenses of both sides of the litigation if they fail.[568] The normal American rule is that, with a few exceptions, both parties bear their own litigation expenses including the attorney's fees.[569]

Nevertheless, as mentioned in Section 3.1.1.3, the security-for-expenses statute has not worked well in deterring 'strike suits' since the plaintiff shareholders can avoid the requirement by several means. For example, the plaintiff shareholders may plead a federal cause of action instead of a state one; or the plaintiffs may look for other shareholders to join in the case in order to satisfy the minimum holding condition and so avoid the security-for-expenses requirement.[570] The plaintiffs' seeking joiners in a case may also be enough to cause the corporation to give up their demand for security from the plaintiffs because such a search might lead to publicity about the dispute, which the corporation does not want.[571] On the other hand, since most of the security-for-expenses statutes base the application of the requirement on the share interests held by the plaintiffs rather than on the cause of the action, it may deter meritorious cases as well. Therefore, most states including Delaware, as well as the revised MBCA and the ALI Principles, have not adopted this requirement.

565 Such as N.Y. Bus. Corp. L. s 627 (Westlaw: McKinney's Business Corporation Law s 627). Also see DeMott (2003), Section 4.06.

566 Hamilton (2000), pp. 546-547; Ferrara et al. (2005), Section 4.06.

567 Hamilton (2000), pp. 546-547; Ferrara et al. (2005), Section 4.06.

568 Hamilton (2000), p. 547.

569 DeMott (2003), Section 3.1, p. 3-3. For a discussion of the allocation of litigation costs in American law, see Section 3.4.4.1.

3.4.3 *The independent body's view*

Under American law the board of directors is generally regarded as the appropriate body to make litigation decisions for the corporation. As mentioned in Section 3.4.2.2.2.3.3, where a majority of the board is not disinterested or independent, an independent body, the special litigation committee, which is composed of disinterested and independent members, may be authorized to make such a decision. The binding effect of the special litigation committee is subject to the standard of judicial review, which varies greatly in different jurisdictions. For a detailed discussion of the issue, please refer to Section 3.4.2.2.2.3.3.

3.4.4 *Incentives for the plaintiff to pursue derivative actions*

3.4.4.1 *Litigation costs and indemnity to the plaintiff shareholder*

Unlike the English principle of costs allocation where 'the costs follow the event'[572], the general American rule is that each party bears his own litigation costs including attorney's fees; the prevailing party's costs will not be shifted to the non-prevailing party.[573] Nevertheless, there is one exception to the rule, which is known as the 'common fund' doctrine.[574] According to this doctrine, the plaintiff who produced or preserved a 'common fund' that benefits others can recover attorney's fees out of the fund based on the principle of unjust enrichment.[575] Since in almost all derivative actions the corporation rather than the plaintiff shareholder gets the recovery, if any, the 'common fund' doctrine in fact governs the allocation of fees in derivative actions.[576] Furthermore, in order for the corporation to pay the attorney's fees in derivative actions, it is not necessary for the corporation to be awarded an actual recovery. A substantial or tangible benefit such as non-pecuniary remedies to the corporation is sufficient, for example, nullification of an election of directors, cancellation of a disadvantageous contract or transaction, obtaining an injunction against mis-management, or making some procedural changes.[577]

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570 Ferrara et al. (2005), Section 4.06.

571 Ferrara et al. (2005), Section 4.06.

572 See Section 2.4.1.4.1.

573 DeMott (2003), Section 3:1, p. 3-3.

574 Coffee (1986), p. 670, Footnote 2.

575 Coffee (1986), p. 670, Footnote 2; DeMott (2003), Section 6:12, pp. 6-32 – 6-33.

576 The allocation of attorney's fees in class actions is also governed by the 'common fund' doctrine since in class actions other shareholders rather than the plaintiff shareholder also benefit from the litigation. Coffee (1986), p. 670, Footnote 2; DeMott (2003), Section 6:12, pp. 6-32 – 6-33.

577 Cox & Hazen (2002), 466-467; DeMott (2003), Section 6:15. However, we should note that due to the 'common fund' doctrine and the indemnification of costs to directors, the corporation in derivative actions will indeed bear the legal expenses of both plaintiffs and defendants; DeMott (2003), Section 6:1, pp. 6-2 – 6-3.

Although the fundamental justification for indemnifying the plaintiff shareholder in derivative actions is to prevent unjust enrichment and to achieve fairness[578], shifting the costs from the plaintiff shareholder to the corporation also relieves the financial burden from the plaintiff and therefore reduces the plaintiff's under-incentive problem as far as bringing derivative actions is concerned.

3.4.4.2 The contingency fee arrangement

A plaintiff shareholder in a derivative action, even if he has failed in the litigation, may not be burdened with litigation costs because of the contingency fee arrangement, which has been available in the United States for over a hundred years and is widely applied in derivative actions.[579] According to the contingency fee arrangement, the plaintiff's attorney will receive compensation only if the suit is successful on the merits or if the case settles. Unlike the English negative attitude towards the contingency fee arrangement, American law takes a favorable approach since it may encourage private enforcement of rights.[580] First, with the contingency fee arrangement, a plaintiff who has no financial support is then able to bring actions. Additionally, a shareholder may also be more willing to bring representative actions (including both derivative actions and class actions) since he need not worry about the attorney's fees if he loses the case. Second, as the attorney will be compensated only by winning or settling the case, there is an incentive to find and take meritorious cases. Unlike the traditional English concern that such an arrangement may violate public policy, 'Americans sincerely feel that a lawyer who satisfies himself as to the merits before taking a cause and who relies for compensation entirely upon a successful result cannot be considered as having a lower standard of ethics than one who prosecutes or defends for an assured fee – regardless of the merits'.[581]

However, despite the justifications for it, the contingency fee arrangement has given rise to the notorious problem of attorney-driven derivative actions, which I will discuss in the following section.

3.4.4.3 The attorney-driven problem

Few of the consequences of litigation born by the plaintiff shareholder

The plaintiff shareholder in a derivative action in fact bears few of the consequences of litigation, no matter whether he prevails or not. If the plaintiff prevails, on the one hand, the recovery will be awarded to the corporation and the plaintiff will be only indirectly benefited via the increase of value of the shares,

578 DeMott (2003), Section 6:16.
579 Hornstein (1967), p. 286.
580 For this American approach and the reasons, see for example Hornstein (1967), p. 286; Coffee (1986), p. 679.
581 Hornstein (1967), p. 286.

which is generally only nominal; on the other hand, the attorney's fees will be paid by the corporation due to the 'common fund' doctrine. If the plaintiff fails in the case, he will not lose much either; he will not need to pay the attorney's fees due to the contingency fee arrangement.[582] In addition, the plaintiff cannot be paid for any work on the case.[583] In fact, although the plaintiff has no under-incentive problem in initiating a derivative action, neither has he a positive incentive to do so especially in large public corporations because of the rational apathy or free-ride problem.

Problems entailed in the attorney-driven feature

Unlike the plaintiff, the plaintiff's attorney has a direct interest in derivative actions due to the contingency fee arrangement. This, together with the fact that attorneys in derivative actions are generally specialists in the area, generates the feature of attorney-driven derivative actions: the plaintiff's attorney may be the real moving force behind the derivative action.[584]

Although the attorney-driven feature does have the advantage of encouraging the private enforcement of rights and disciplining corporate management, it also causes problems. On the one hand, due to the plaintiff's nominal stake in the derivative action and the problem of rational apathy, there is hardly any client control of the attorney's pursuit of his personal interests.[585] On the other hand, the attorney's interests are generally not congruent with the interests of the corporation and its shareholders. Therefore, derivative actions are mainly pursued for the best interests of the attorney rather than the corporation and its shareholders. For example, generally settlement is more favorable to the attorney than a trial since the attorney normally prefers an assured amount awarded by the settlement to the uncertain result of a trial.[586] In addition, since the attorney's interest lies in the amount of money he receives less the costs spent on the case, the attorney's interest is usually better served by settlement because he can receive a relatively high attorney's fee with less costs than the work required to prepare and take the case to trial.[587] Whether the corporation can obtain sufficient recovery is beyond the attorney's concern. This is the reason why most derivative actions are settled and do not go to trial and appeal.[588]

The attorney-driven feature may also cause a problem of over-enforcement.[589] Attorneys may bring actions of doubtful merit solely for their nuisance settlement

582 Cox (1999), p. 31.
583 DeMott (2003), Section 6:12, pp. 6-33 – 6-34.
584 DeMott (2003), Section 6:2, p. 6-4; Hamilton (2000), p. 539.
585 Coffee (1986), pp. 679-680.
586 DeMott (2003), Section 6:3, p. 6-7;
587 *Saylor v. Lindsley*, 456 F.2d 896, 900-901 (2d Cir. 1972); also see Cox (1999), p. 33.
588 Hamilton (2000), p. 540.
589 Coffee (1986), pp. 680-681.

value, in disregard of corporate interests.[590] This over-enforcement may unjustly interfere with corporate management.

Restrictions on the settlement of derivative actions

In order to reduce the negative effect of the attorney-driven feature, American law has adopted several mechanisms to restrict the bringing of derivative actions and to protect directors, which I have discussed. In addition, in order to prevent the plaintiff's attorney from serving his own interests rather than the interests of the corporation and its shareholders, there have been restrictions placed on the settlement of derivative actions. The Federal Rule of Civil Procedure section 23.1 requires that the proposed settlement or dismissal of derivative actions should be approved by the court and 'notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.' The requirement of judicial approval for the proposed settlement or dismissal has been adopted by most state law as well as by the MBCA and the ALI Principles.[591] However, different approaches have been taken toward the notice requirement. For example, some states also adopt the notice-to-shareholders requirement, while others give the court the discretion to decide whether such a notice is necessary. In Delaware notice is required unless the dismissal of the action is without prejudice to the plaintiff.[592] The MBCA provides that 'If the court determines that a proposed discontinuance or settlement will substantially affect the interests of the corporation's shareholders or a class of shareholders, the court shall direct that notice be given to the shareholders affected'.[593] A similar approach to the MBCA has been taken by the ALI Principles.[594]

3.4.5 Limiting directors' financial exposure to the risks and costs of litigation

In order to strike a balance between corporate efficiency and protection for minority shareholders, American law also provides defendant directors protection by limiting their financial exposure to the risks and costs of litigation. Such

590 Coffee (1986), pp. 680-681; DeMott (2003), Section 6:3, p. 6-7. However, it is also argued that the strike suit in derivative actions is relatively uncommon because settlement for strike suits would establish defendants, as repeat players with a reputation as 'an easy mark,' and involve them in more strike suits and because bringing a strike suit would also incur substantial risk to the plaintiff attorney; in addition, strike suits are unlikely to cause great burden on defendants since the plaintiff's attorney is likely to settle the case for a very low figure; see Macey & Miller (1991), p. 78.

591 See, for example, Del. Ch. R. 23.1, N.Y. Bus. Corp. L. section 626(d) (Westlaw: McKinney's Business Corporation Law 626(d)), the MBCA, section 7.45, ALI (II) Section 7.14(a); see Ferrara et al. (2005), Section 14.01.

592 DeMott (2003), Section 7:1, p. 6-51.

593 MBCA, S7.45.

594 ALI (II) Section 7.14(c).

protection, like the business judgment rule, is intended to encourage more capable people to serve as directors and therefore benefit the corporation and shareholders in the end.[595] Such methods of protection include exculpation of directors' personal liability to a certain extent, indemnification of directors' litigation expenses by the corporation, and D&O insurance provided by the corporation. I will discuss these methods in the following sections in turn.

3.4.5.1 Eliminating or limiting (exculpation of) directors' personal liability

Background

Most states' corporation statutes allow for a corporation's articles or certificate of incorporation to include a provision to eliminate or limit directors' personal liability for financial damages to the corporation or its shareholders, with certain limited exceptions. This legislative practice started with section 102(b)(7) of the Delaware General Corporation Law (DGCL), which was added in 1986.

Section 102(b)(7) of DGCL was the direct statutory reaction to the Delaware Supreme Court case of *Smith v. Van Gorkom*.[596] The *Van Gorkom* case was regarded as Delaware law tightening the legal constriction on directors.[597] In this case, the Delaware Supreme Court, by a 3(2 vote, held that the directors of Trans Union Corporation could not be protected by the business judgment rule because they had acted with gross negligence and had then violated their fiduciary duty by accepting a merger proposal after only two hours of consideration and without examining relevant documentation, although in this case, the price of the offer was substantially higher than the market price.[598] While the court, in making its decision, properly focused on the process of the decision rather than the outcome of the decision[599], the case has been greatly criticized for its strict application of the business judgment rule. Dissenters argued that the facts of the case could not show that the directors were not acting on a well-informed basis or had acted with gross negligence. On the contrary, the directors were sophisticated businessmen and 'were more than well qualified to make on the spot informed business judgments concerning the affairs of Trans Union including a 100 percent sale of the corporation'.[600]

Before the *Van Gorkom* case, courts hardly ever found directors grossly negligent or examined business decisions without evidence of bad faith.[601]

595 Veasey & Guglielmo (2005), p. 1433.
596 488 A.2d 858 (Delaware 1985).
597 Bradley & Schipani (1989), p. 42.
598 488 A.2d 858, 874-876 (Delaware 1985).
599 488 A.2d 858, 878 (Delaware 1985).
600 488 A.2d 858, 895 (McNeilly, J., dissenting) (Delaware 1985).
601 Bradley & Schipani (1989), p. 42, p. 44.

Therefore, the case inevitably generated the concern that the decision would weaken the business judgment rule and expose directors to serious liabilities.[602] In fact, there was an immediate response to the *Van Gorkom* case in the business community: D&O liability insurance premiums increased and fewer qualified people were willing to serve as directors.[603] These changes directly led to the enactment of Section 102(b)(7) of the DGCL, which was intended to alleviate the negative effect of the *Van Gorkom* case and provide protection for directors.

Section 102(b)(7) of DGCL

Section 102(b)(7) of DGCL permits a corporation's certificate of incorporation to include:

> A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director (i) for any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under section 174 of this Title; or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective ...[604]

As we have seen, exculpation of directors' liability under section 102(b)(7) entails certain restrictions. First, section 102(b)(7) provides an 'opt in' election and, therefore, the corporation's certificate of incorporation must be amended to include such a provision in order to exculpate directors from liability. Directors' liability for any act or omission occurring before the date when such provision becomes effective will not be exculpated either. Second, only directors (not officers or other agents) may be protected by such a provision. Third, such a provision may only exculpate directors from liability for financial damages; other remedies, such as injunction or setting aside a transaction, are beyond the provision's protection.[605] Fourthly, only a director's liability to the corporation and its shareholders, rather than to third parties, may be exculpated by such a

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602 Bradley & Schipani (1989), p. 7.

603 Hamilton (2000), pp. 458-459; Bradley & Schipani (1989), p. 7, p. 43; Veasey & Guglielmo (2005), p. 1432. Bradley and Schipani also did empirical studies on the effect of the case on the market for directors' and officers' liability insurance, see Bradley & Schipani (1989), pp. 49-57.

604 DGCL s 102(b)(7) (Westlaw: 8 Del. Code Ann. s 102(b)(7)). Section 174 of Title 8 imposes joint and several liability on directors under whose administration a corporation unlawfully pays a dividend or unlawfully purchases or redeems stock.

605 DeMott (2003), Section 1:7, p. 1-31; Veasey & Guglielmo (2005), pp. 1432-1433.

provision. Finally, such a provision can only exculpate directors from liability for duty-of-care violations.

Statutes in other states, the MBCA and the ALI's Principles

Section 102(b)(7) of DGCL was obviously welcomed. After its enactment, many corporations amended their certificates of incorporation to include such an exculpation provision.[606] Soon after Delaware, many other states also introduced a similar section into their own corporation statutes, as well as the MBCA.[607] Some of the states and the MBCA take a more pro-management approach than does Delaware in a few details. For example, Section 2.02(b)(4) of the MBCA narrows the exceptions to exculpable liability more than does section 102(b)(7) of the DGCL. Therefore more violations by directors may be exculpated from liability.[608] Instead of Delaware's opt-in approach, some states choose to have the statutes automatically limit directors' personal liability under certain circumstances.[609] In addition, some states permit officers, as well as directors, to be protected by such an exculpation provision.[610]

The ALI Principles also include a similar limitation on directors' liability in section 7.19. Furthermore, section 7.19 suggests that such a provision in a certificate of incorporation to limit directors' liability for certain violations of the duty of care should be upheld by the court even in the absence of an enabling statute, except as otherwise provided by statute.

Effects of the exculpation of directors' liability on the corporation and its shareholders

Section 102(b)(7) of the DGCL and those following are intended to protect directors and encourage more competent people to serve as directors and, therefore, reverse the trend towards stricter constraint on directors created by the *Van Gorkom* case.[611] Since under such a regulation directors who were held liable

606 Hamilton (2000), P. 459.

607 MBCA, Section 2.02(b)(4). For a detailed introduction to the statutes in various states, see DeMott (2003), Section 1:7.

608 Section 2.02(b)(4) of the MBCA provides that the articles of incorporation may set forth 'a provision eliminating or limiting the liability of a director to the corporation or its shareholders for money damages for any action taken, or any failure to take any action, as a director, except liability for (A) the amount of a financial benefit received by a director to which he is not entitled; (B) an intentional infliction of harm on the corporation or the shareholders; (C) a violation of Section 8.33; or (D) an intentional violation of criminal law.' Section 8.33 of the MBCA imposes directors' liability for voting or assenting to unlawful distributions.

609 Such as India and Ohio; see DeMott (2003), Section 1:9.

610 Such as Maryland, Nevada, New Hampshire and New Jersey; see DeMott (2003), Section 1:7, pp. 1-33 – 1-34.

611 Hamilton (2000), p. 460; Bradley & Schipani (1989), p. 44; Veasey & Guglielmo (2005), p. 1434.

to the corporation and its shareholders may be exculpated from financial damages to the corporation and its shareholders, a concern may arise as to whether this exculpation might injure the interests of the corporation and its shareholders. The answer may be negative. First of all, the statutes normally include a wide scope of exceptions. The major causes of derivative action, such as an unlawful act or the breach of duty of loyalty, are probably not exculpated. Second, the willingness of more competent people to serve as directors and the ensuing lower price for D&O liability insurance may improve corporate management and at the same time lower its costs.[612] Third, where directors' liability can be exculpated, the court may tend to examine the board's decision more closely without fearing that the substitution of the court's judgment for the board's decision would make individual directors liable.[613] This tendency may make it easier for the plaintiff shareholder to access derivative actions and acquire remedies other than money damages.[614] Fourth, the statute may encourage plaintiff shareholders to bring derivative actions as soon as possible in order to prevent misconduct to the corporation rather than to wait and seek damages after injury has been caused.[615] Fifth, the exculpation of money damages will not affect the plaintiff's incentive to bring derivative actions because the plaintiff can still have his attorney's fees indemnified by the corporation if appropriate equitable relief is awarded.[616] Finally, it is quite normal that the wrongdoers cannot pay all damages even if there is no such exculpation.

3.4.5.2 Indemnification of directors

All American states have indemnification statutes that mandate or permit corporations to reimburse their directors or officers for litigation costs that are directly related to the performance of their duties.[617] Indemnification applies to all kinds of litigation. Depending on the circumstances, the costs that may be indemnified include (1) expenses incurred in defending the case including legal fees, and/or (2) fines, judgments, or amounts incurred in settlement of the case.[618]

The rationale behind the indemnification principle is that acting as agents of the corporation the directors and officers should be able to be compensated by the corporation for costs arising from the performance of their duty if the performance is faithful.[619] Another consideration is to provide protection for

612 The empirical study done by Bradley and Schipani shows the response of the D&O liability insurance market to the statute; see Bradley & Schipani (1989), pp. 49-57.

613 Cox & Hazen (2002), p. 201.

614 Cox & Hazen (2002), p. 201.

615 Cox & Hazen (2002), p. 201; Hamilton (2000), p. 460.

616 Cox & Hazen (2002), p. 201.

617 For a detailed introduction to state statutes as well as federal law, see, for example, DeMott (2003), Sections 6.35-6.44.

618 Hamilton (2000), p. 524.

619 Ferrara et al. (2005), Section 12.01.

directors and officers.[620] As mentioned in Section 3.4.4.1, the general American rule is that each party bears its own litigation costs including attorney's fees; the prevailing party's costs will not be shifted to the non-prevailing party.[621] Therefore, the indemnification principle is important for directors and officers. Indemnification may be mandatory or permissive. For example, the Delaware statute provides that a director, officer, employee or agent of a corporation, in defense of any action, suit or proceeding, 'shall be indemnified against expenses (including attorneys' fees) actually and reasonably incurred by him in connection therewith' to the extent that he 'has been successful on the merits or otherwise'.[622] When the director is not successful, the Delaware statute permits, but does not require, corporations to indemnify him under certain circumstances.[623]

Most indemnification statutes are non-exclusive.[624] Therefore, a corporation may also assume an indemnification obligation, either mandatory or discretioary, for its directors or officers by means of a provision in the articles of incorporation, through by-laws or by an agreement with the individual director or officer, subject to the restrictions in the statute and public policy.[625]

Courts may also have the discretion of deciding whether to grant indemnification based on certain considerations, for example, whether the indemnification is fair and reasonable.[626]

It is important to note that most indemnification statutes distinguish third-party litigation from actions brought by or on behalf of the corporation (that is, the derivative action).[627] Where the litigation is based on a third-party's right, the director may be indemnified by the corporation against both (1) reasonably incurred expenses (including attorneys' fees and fees incurred in prosecuting an indemnification claim) and (2) judgments, fines and amounts paid in settlement, provided he satisfied the statutory standards such as acting in good faith and reasonably believing that the conduct was in, or not opposed to, the best interests of the corporation and was not illegal.[628] However, while the action was brought by or on behalf of the corporation, the director may only be indemnified against reasonably incurred expenses if the statutory standards for the indemnification are satisfied. There can be no indemnity against judgments or amounts paid in

620 Ferrara et al. (2005), Section 12.01.
621 DeMott (2003), Section 3:1, p. 3-3.
622 DGCL, s 145(c) (Westlaw: 8 Del. Code Ann. s145(c)).
623 DGCL, s 145(a)(b) (Westlaw: 8 Del. Code Ann. s145(a)(b)).
624 Ferrara et al. (2005), Section 12.07.
625 Ferrara et al. (2005), Sections 12.05 and 12.07.
626 See, for example, DGCL, s 145(b) (Westlaw: 8 Del. Code Ann. s145(b)); ALI (II) Section 7.20 (b)(c); MBCA, section 8.54. For a detailed introduction to court-ordered indemnification, please see, for example, Ferrara et al. (2005), Section 12.08.
627 Ferrara et al. (2005), Section 12.06; Bradley & Schipani (1989), p. 31.
628 See, for example, DGCL, s 145(a) (Westlaw: 8 Del. Code Ann. s145(a)).

settlement.[629] The rationale is that indemnification against judgments or amounts paid in settlement would cause an unwanted circular transfer of funds: the money paid by the liable director to the corporation would go back to the director through the indemnification.[630]

However, both the ALI Principles and the MBCA take a more pro-management approach. The ALI suggests that a court should have the discretion to order indemnification for amounts paid in the settlement of a derivative action.[631] The MBCA goes further. According to the MBCA, with regard to a proceeding by or on behalf of the corporation, even if a director was adjudged liable and failed to meet the relevant standard of conduct set forth in Section 8.51(a) of the MBCA, a court can still order indemnification for him, but the indemnification 'shall be limited to reasonable expenses incurred in connection with the proceeding.'[632] Therefore, according to the MBCA, amounts paid in settlement of, or judgments resulting from, derivative actions may be indemnified if it is reasonable to do so.[633] There is also a trend among some states to take a more liberal approach: a wider scope of expenses, such as amounts paid in settlement or even judgment, may be indemnified in derivative actions in some states.[634]

Almost all statutes permit, but do not require, a corporation to advance funds for expenses to directors before the final termination of litigation.[635] This advance for expenses is important in a practical way for directors since they may face financial difficulty in defending against litigation without such an advance.[636] However, in order to obtain the funds, the director may need to satisfy several conditions.[637] The director must repay the funds if found in the end not to be entitled to the indemnification.[638]

3.4.5.3 D&O insurance

Most state statutes expressly allow the corporation to purchase liability insurance on behalf of its directors, officers and agents, which is generally known as D&O insurance.[639] The coverage of a typical D&O policy includes two parts: one part

629 See, for example, DGCL, s 145(b) (Westlaw: 8 Del. Code Ann. s145(b)); ALI (II) Section 7.20(b)(1)(D).
630 Ferrara et al. (2005), Section 12.06, [2].
631 ALI (II) Section 7.20(c)(2).
632 MBCA, section 8.54(a)(3).
633 Ferrara et al. (2005), Section 12.08.
634 Ferrara et al. (2005), Section 12.06, [2].
635 Ferrara et al. (2005), Section 12.11.
636 Ferrara et al. (2005), Section 12.11.
637 Ferrara et al. (2005), Section 12.11.
638 Ferrara et al. (2005), Section 12.11.
639 Hamilton (2000), p. 534; DeMott (2003), Section 6:45, p. 6-190; Ferrara et al. (2005), Section 13.02.

reimburses the corporation for its losses arising from indemnification payments made to its directors and officers; the other part reimburses the individual directors or officers for their losses for which indemnification by the corporation may not be available.[640] Recently, a new entity coverage, which provides direct liability coverage for claims against the corporation, has also been developed.[641]

D&O insurance obviously benefits the corporation as well as its directors and officers. Via the insurance, the corporation can transfer to the insurer at least part of its losses arising from the indemnification.[642] The individual directors and officers also benefit as the insurer may reimburse them against losses that the corporation may not indemnify. Moreover, the insurance will make sure that they will be indemnified even if the corporation has financial problems or is in reorganization.[643]

The D&O policy may cover a wider range of losses than those that could be indemnified by the corporation, while at the same time being subject to less restriction.[644] This is due to the different bases for the insurance and indemnification. Exculpation of liability and indemnification in fact shift the burden of financial costs, which arose from the director or officer's actual or alleged misconduct, from the individual director or officer onto the corporation, while the D&O insurance then actually shifts the burden of financial costs to a third-party insurer, who acquires premium payments in return.[645] The major concern under indemnification is fairness, while under the D&O insurance arrangement it is risk spreading.[646]

However, the scope of D&O insurance coverage may be limited. Some states, such as New York, place statutory restrictions on that scope.[647] Public policy may also void the insurance in cases of certain types of misconduct.[648] In practice, although D&O policies vary greatly from insurer to insurer, they generally place a restriction on the scope of the coverage. It is common for dishonest acts, acts in bad faith and acts intentionally in violation of law to be excluded from the coverage.[649]

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640 Ferrara et al. (2005), Section 13.01; DeMott (2003), Section 6:45, p. 6-191; Cox & Hazen (2002), pp. 476-477.

641 Ferrara et al. (2005), Section 13.01.

642 Ferrara et al. (2005), Section 13.01; Hamilton (2000), pp. 532-533.

643 Ferrara et al. (2005), Section 13.01; Hamilton (2000), pp. 532-533.

644 Ferrara et al. (2005), Section 13.01.

645 Ferrara et al. (2005), Section 13.01.

646 Ferrara et al. (2005), Section 13.01.

647 N.Y. Bus. Corp. L. s 726 (Westlaw: McKinney's Business Corporation Law s 726). Ferrara et al. (2005), Section 13.02; Cox & Hazen (2002), p. 477.

648 Cox & Hazen (2002), p. 477.

649 Hamilton (2000), p. 533. Also see Ferrara et al. (2005), Section 13.04[1].

3.4.6 The shareholder's right to information

Whether the plaintiff shareholder can acquire enough evidence is, for practical purposes, important in the exercise of his right to derivative actions. Generally, American law is unfavorable to the plaintiff shareholder in this respect, who has to bear the burden of proof in order to rebut the business judgment rule or to plead demand futility.[650] At the same time discovery is generally not available to the plaintiff and so it remains difficult to acquire the evidence necessary for the case. In order to improve the plaintiff's position, recent Delaware law has encouraged plaintiffs to use the 'tools at hand.' Section 220 of the DGCL actually does provide shareholders with the right to inspect certain corporate books and records in order to obtain information for the purpose of their pleadings in derivative actions.[651] This application of section 220 has, in fact, contributed to the function of derivative actions in Delaware.[652]

3.5 Conclusion

3.5.1 The function of derivative action in American corporate governance

It is generally acknowledged that derivative actions play an important role in American law, protecting the corporation and its minority shareholders. This is still true, even though such a role is not as important as it used to be because of the development of other mechanisms of corporate governance and also because of the recently added restrictions on the shareholder's right to derivative actions, such as the special litigation committee. We should also note that derivative actions may play a less important role in close corporations than in public corporations due to the special treatment given to close corporations. Lastly, our study also shows that even in the United States, where derivative actions do play an important role, the debate on how important that role should be is still ongoing.

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650 See Sections 3.4.1.2 and 3.4.2.2.2.2.1.

651 For example, *Grimes v. DSC Communications, Corp.*, 724 A.2d 561 (Del. Ch. 1998); *Brehm v. Eisner*, 746 A.2d 244 (Delaware 2000); *Beam v. Stewart*, 833 A.2d 961, (Del. Ch. 2003). Also see Ferrara et al. (2005), Section 7.03; Veasey & Guglielmo (2005), pp. 1466-1468.

652 Veasey & Guglielmo (2005), p. 1497.

3.5.2 *The American model of striking a balance between corporate efficiency and protection of the interests of the corporation and its minority shareholders*

3.5.2.1 *Overview*

As mentioned, derivative actions have played an important role in the United States in protecting the interests of the corporation as well as its shareholders and in disciplining corporate management. Compared with other countries such as England and Germany, American law has tried to strike a fair balance between these two competing interests, rather than favoring one over the other. For example, as mentioned by Veasey and Guglielmo, Delaware law, the most important state corporate law, takes 'a bilateral approach to balancing corporate interests' by favoring both stockholder and managers, and the Delaware Supreme Court also tends toward consensus.[653] This balance is regarded as helping to ensure that Delaware maintains 'its competitive edge in the incorporation race – an edge which would be lost were Delaware law to favor one corporate constituency over another'.[654] Even after the legal changes in the aftermath of Enron and other corporate scandals, this tendency toward balancing has still been maintained. 'Delaware courts today are not any more "pro-stockholder" and less "pro-director" or "pro-manager" than they were in the past, or vice versa'.[655]

The historical development of derivative actions also shows the efforts of American legislatures and courts to strike such a balance. As mentioned in Section 3.1.1, originally it was relatively easier for an individual shareholder to bring a derivative action and the scope for causes of derivative action was also wider. However, due to the emergence of strike suits and changes in society, new obstacles were then developed in order to restrict derivative actions. In sum, the history of the derivative action is indeed 'an expression of the tension between shareholders and management'.[656]

After more than a hundred years of development, American law, when it comes to striking a balance, has its own features, which I will discuss in the following sections.

3.5.2.2 *The appropriate body to make corporate litigation decisions*

There is no doubt that an individual shareholder has the right to enforce corporate claims by initiating a derivative action. Nevertheless, when it comes to which is the more appropriate body to make these corporate litigation decisions apart from

653 Veasey & Guglielmo (2005), pp. 1501-1502.
654 Veasey & Guglielmo (2005), pp. 1501-1502.
655 Veasey & Guglielmo (2005), p. 1496.
656 Ferrara et al. (2005), Section 1.03.

the individual shareholders themselves, American law has undergone some changes.

As in other countries, American law has traditionally regarded the board of directors as the most appropriate body for making corporate litigation decisions. Therefore, a plaintiff shareholder must put a demand before the board before he initiates a derivative action. Nevertheless, American law also recognizes the fact that the board may not make a fair litigation decision due to various reasons such as conflict of interest. Therefore, a demand made on the board may be excused in certain situations and the board's litigation decision may also be subjected to judicial review.

Although shareholders collectively were regarded as the appropriate body to make corporate litigation decisions, many American states have abandoned this approach. As a result, only in a minority of states is a demand on the general meeting of shareholders now required before initiating a derivative action. And such a demand on the general meeting may also be excused in certain situations.

Since the mid-1970s, in some states an independent body in the corporation, the special litigation committee, has begun to play an important role in making corporate litigation decisions where the board had a conflict of interest and is regarded as inappropriate for making these decisions. Such a special litigation committee, which is composed of independent directors, may make a decision not to sue against the corporate claims and therefore bar a shareholder's derivative action. In fact, the special litigation committee can be a significant obstacle to the shareholder's right to bring derivative actions. Of course, the decision of the special litigation committee is also subject to judicial review, the standard of which differs greatly from state to state.

By exercising its judicial review over the board or the special litigation committee's litigation decision, and by approving a proposed settlement or dismissal of a derivative action, American courts also play an important role as far as the corporate litigation decision is concerned.

3.5.2.3 Both facilitating and controlling derivative actions

American law tries to strike a balance by both facilitating and controlling derivative actions. On the one hand, it is easier for an individual shareholder to bring a derivative action for reasons of corporate misconduct in the United States than it is in other countries. For example, there is no capital threshold requirement for bringing derivative actions, the standing requirements are not strict and there is a wide scope of causes of derivative action.

On the other hand, American law at the same time has developed several mechanisms to control derivative actions and to avoid strike suits. For example, the plaintiff shareholder must make a demand on the board of directors or plead demand futility before initiating a derivative action. In some states, a demand on the shareholders collectively or a pleading of such a demand futility is also necessary. Even in demand-excused cases, the special litigation committee's decision not to sue may also bar a derivative action. In some states, a plaintiff

shareholder, who holds less than the statutorily required minimum interest in the corporation, may be required to post security for reasonable expenses. In addition, a proposed settlement or dismissal of a derivative action generally should be approved by the court, and in some states a notice to shareholders of such a settlement or dismissal is also required. These mechanisms, although having their own particular history and rationale, are all purported to screen and dismiss non-meritorious strike suits, without excessively disqualifying meritorious suits.[657]

3.5.2.4 Providing protection for directors

It is widely accepted in the United States that qualified persons, when facing the high risk of liabilities for their decisions, may be unwilling to serve as corporate directors. This would, in reverse, negatively affect the interests of the corporation and its shareholders. Therefore, American law has adopted several mechanisms to limit directors' exposure to liabilities. The most important one is the business judgment rule, which restricts judicial review of a director's behavior to a certain extent and provides a safe harbor for directors. There are also mechanisms that eliminate or limit directors' financial exposure to the risks and costs of litigation in certain circumstances, even if they have been held liable. The mechanisms include, for example, provisions in the articles or certificates of incorporation to eliminate or limit a defendant director's personal liability to a certain extent, along with indemnification of directors' litigation expenses by the corporation, and D&O insurance provided by the corporation.

3.5.2.5 Distinguishing between duty of loyalty and duty of care[658]

Under American law the duty of loyalty, including the duty to act in good faith and in the best interests of the corporation, is generally more rigorously enforced than the duty of care.[659] For example, those mechanisms which are mentioned in Section 3.4.5 to protect directors are generally not applicable to a director's breach of duty of loyalty.[660] Another example is Delaware's different standards of judicial review concerning directors' litigation decisions in demand-required and demand-excused cases. In demand-excused cases where it is more doubtful whether directors can fulfill their duty of loyalty, a higher standard of judicial

657 Scott (1983), p. 942.

658 Although there is disagreement whether good faith belongs to the duty of loyalty or the duty of care, I take the approach that the duty of loyalty includes the duty to act in good faith and in the best interests of the corporation, as well as including no self-dealing. Also see Veasey & Guglielmo (2005), p. 1451.

659 Butler (2000), p. 591.

660 The scope of specific applications of the mechanisms varies to a certain extent; for details, see Section 3.5.

review is applied than that applied in demand-required cases.[661] In fact, in practice there are very few cases that impose liability merely based on the breach of duty of care.[662]

By acknowledging that derivative actions historically play a less important role in enforcing the duty of care than they do in enforcing the duty of fair dealing, the ALI Principles also suggest a dual standard of judicial review: a closer judicial scrutiny should apply to the directors' breach of duty of loyalty than that applied to the breach of duty of care.[663]

This differing enforcement of the duty of loyalty and of the duty of care does, in fact, generate debate, at least among scholars, as to whether completely different sets of legal rules should apply to the two kinds of breaches.[664] Scott even suggests abolishing derivative actions based on the breach of duty of care.[665]

3.5.2.6 The court's role in derivative actions

American courts have been playing an important role in derivative actions by balancing corporate management and the interests of the corporation and its shareholders. For example, the application of the business judgment rule to restrict a director's liability for certain breaches of duties, as well as the demand requirement, which are the two most important restrictions on derivative actions, both involve the court's participation. In fact, the court's attitude has played a decisive role in the effect of derivative actions. *Smith v.van Gorkom* is an obvious illustration of this role. In addition, because a proposed settlement or dismissal of derivative actions must be approved by the court, the court also plays an important role in derivative actions when the high percentage of settlements in derivative actions cases is taken into account.

661 See Section 3.4.2.2.2.3.

662 Scott (1983), p. 933; Bishop (1968), p. 1099.

663 See Section 3.4.2.2.2.3.4.

664 Ribstein (1986), pp. 367-371.

665 Scott (1983), pp. 935-937. Scott's suggestion has been disagreed with by other scholars, such as Cox (1984), pp. 759-763.

Chapter 4

Germany

4.1 Introduction to the German rules

German law on derivative actions has recently experienced changes. Historically the derivative action in the common law sense did not exist for Germany except in groups of companies.[1] Previous German law strictly insisted on the general principle that an action enforcing corporate claims had to be brought in the name of the company. Although minority shareholders had the right to enforce corporate claims, they only had the right to initiate the assertion of corporate claims (or in other words, the right to cause the company or a special representative to bring corporate claims) rather than the right to bring a derivative action as in England and the United States. However, this situation changed on November 1, 2005, when a new statutory derivative action was introduced into German law as part of the new German Act Regarding Integrity of Companies and Modernization of Shareholder Suits (Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts), the so-called UMAG, which came into force on that date. The UMAG significantly amended the German Stock Corporations Act (the AktG) in many respects, including the shareholders' right to bring a derivative action.

In this chapter I will be discussing these new rules for derivative actions under the UMAG, as well as the former rules covering the shareholders' right to cause the company or a special representative to enforce corporate claims. It is necessary to discuss these previous rules because the UMAG has been effective for only a short period and so its effect still remains to be seen, and in addition, because a comparison of the current and the former rules will help us better understand the German law.

4.1.1 Background

Some knowledge of the background of corporate structure in Germany is also necessary for us to understand German law and to compare it with the laws found in other countries. Therefore, this chapter will start there.

1 For details of the rules, please see Section 4.1.3.

First, as in England and the United States, there are two forms of companies that are separate legal entities in Germany: the Aktiengesellschaft (the AG) and the Gesellschaft mit beschränkter Haftung (the GmbH). The AG is generally regarded as the equivalent of the English public company or the American publicly held corporation, while the GmbH is related to the English private limited company or the American closed corporation. However, the differences between these two types of companies under German law are greater than those found under English or American law.[2] In Germany, the two companies are regulated by two separate acts: the Stock Corporations Act (AktG)[3] for the AG and the Limited Liability Company Act (GmbHG)[4] for the GmbH. Although several basic principles, such as the separate legal entity principle and the duties of directors, are similar, many aspects of the two laws are different. For example, the structures of intra-corporate bodies, the division of powers among the bodies, the protection for minority shareholders, as well as the enforcement of directors' liabilities, differ considerably under the two acts.[5] Therefore, in this chapter, many issues will be discussed separately for these two different types of companies.

Second, as far as corporate structure is concerned, German company law is based on a two-tier system.[6] This means that there are two boards within a company: the management board (Vorstand) and the supervisory board (Aufsichtsrat). The supervisory board is mandatory for AGs and large GmbHs in which there are more than five hundred employees.[7] The management board runs the day-to-day business, while the main task of the supervisory board is supervising the operations of the management board.[8] As 'the hinge between shareholders and directors'[9], the supervisory board is especially intended to protect shareholders from any misconduct by the management board.[10] While there is one body of opinion that considers that in practice the two-tier system does not differ so greatly from the Anglo-American one-tier system because in the latter there is also division between 'inside' directors and 'outside' directors[11], in point of fact this two-tier feature does contribute substantially to the difference between German law and Anglo-American law.

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2 See Baums (1996), at p. 318.

3 It was enacted in 1965, and the latest amendment to it was made by the UMAG.

4 It was originally enacted in 1892 but is now in amended form. The latest revision was made in June 1998.

5 For example, see Baums (1996) p. 318; Hopt (1992), p.117.

6 Nevertheless, a Societas Europaea (European Company) may choose between the two-tier board system and the one-tier board system.

7 See Betriebsverfassungsgesetz 1952 (the Labor Management Relations Act 1952), para. 77; as cited in Shearman (1995), p. 519.

8 AktG section 111.

9 Stengel (1998), at p. 49.

10 Chantayan (2002), p. 439; Baums (2002), p. 5.

11 See, for example, Stengel (1998), at p. 49; Baums (2002), p. 5.

Third, the interests of shareholders, especially minority shareholders, are traditionally less prominent in Germany.[12] This is especially the case in public companies. Traditionally Germany favors a stakeholder culture.[13] Shareholders are neither the only, nor the most important concern in German corporate governance. The interests of other 'stakeholders' such as creditors, employees, as well as managers are also taken into consideration by German law, especially in the AG.

Due to this culture, protection of minority shareholders has traditionally been poor under German law and it is generally accepted that to a certain extent minority shareholders have been ignored. In practice, the board of directors usually considers the interests of major shareholders such as banks[14], and neglects the role of individual shareholders. The following quote reflects this attitude well: 'Shareholders are dumb when they buy stock and impertinent because they also want a dividend'.[15] This insufficient acknowledgment of the function of minority shareholders may partly be explained by the lack of mature capital markets. In Germany, a largely dispersed shareholding structure does not exist. For example, the shares of most AGs are still in the hands of a relatively small group of investors, especially banks.[16] These banks, as controlling shareholders, also offer loans to the company. The capital market is not the main source of financing for companies. In addition, individual shareholders normally grant proxies to the banks through which they bought their shares.[17] Therefore, protection of minority shareholders, who invest through capital markets, is not the main concern.[18]

However, for the last decade there has been a trend towards paying more attention to shareholder value in Germany[19], and reforms for improving protection for minority shareholders have been adopted.

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12 This issue, regarded as a weakness under German law, was pointed out by Dr. Gerhard Cromme, the Chairman of the German Corporate Governance Code Commission, in his remarks upon publication of the draft German Corporate Governance Code on December 18, 2001. The Code was adopted in February of 2002. In May 2002, the German Parliament passed the Transparency and Disclosure Act which provides a legislative basis for the Code. For the English version of Dr. Gerhard Cromme's remarks, please refer to http://www.corporate-governance-code.de./eng/news/rede-crommes.html (last visited: August 2006); for the English version of the German Corporate Governance Code, as amended on June 12, 2006, please refer to http://www.corporate-governance-code.de./eng/kodex/index.html (last visited: August 2006).

13 See, for example, André (1998), p. 105.

14 Chantayan (2002), pp. 445-446.

15 Bündnis für Aufschwung; Risikokapital--Der Neue Pflegedienst, Focus Magazin, Mar. 25, 1996, available in LEXIS, World Library, Allwld File ('Aktionäre sind dumm, weil sie Aktien kaufen und frech, weil sie auch noch Dividende kassieren wollen.'), as cited in André (1998), p. 105. Also see Chantayan (2002), p. 445.

16 According to the statistics, in the 1990s nearly 85% of the largest listed companies in Germany had at least one shareholder owning more than 25% of the shares; while in the UK the percentage of such companies was only 16%; see Hirt (2004b), p. 30.

17 Chantayan (2002), pp. 445-446.

18 See Kraakman et al. (2004), p. 129.

19 See André (1998), pp. 109-112; Grub (1999).

4.1.2 Recent reforms concerning corporate governance

4.1.2.1 The reasons for these reforms

Measures to reform corporate governance, including improving protection for minority shareholders and disciplining corporate management, have been adopted in Germany over the last decade. Several factors may account for this reform.[20] The major reasons might well be simply the globalization of the economy and the need to attract investment from both domestic and foreign investors either through foreign capital markets or domestic markets.[21] For these purposes, German law, which is generally regarded as less shareholder-friendly and lacking in judicial control over directors, needed to be changed. Furthermore, the development of European company law has also accelerated the reform of German company law.

Another reason for reform is that the efficiency of the traditional German corporate governance system has been called into question due to the stagnancy of the economy at least since the 1990s, and also due to recent corporate governance scandals in some well-known companies.[22] As mentioned, a feature of German corporate governance is the two-tier system, that is, it is the task of the supervisory board to discipline corporate management and to protect the interests of the company. The power to enforce corporate claims against the managing directors is also granted to the supervisory board. However, the effectiveness of the supervisory board, including the performance of the task of filing a lawsuit against the managing directors, has recently been the target of criticism. Several weak points have been identified. First, the supervisory board is short on the information necessary for it to perform its supervisory task. The separation of powers in the AktG keeps the supervisory board away from management and then makes it difficult for the supervisory board to acquire essential information. The supervisory board normally acquires information from the management board rather than from other sources[23], while the management board usually does not provide the supervisory board with the relevant information.[24] Furthermore, less power and less information has been awarded to the supervisory board under the codetermination system.[25] In this system, the supervisory board is made up of members who are partly elected by shareholders and partly appointed by the employees, and therefore it represents the interests of employees as well as

20 See, for example, Singhof & Seiler (1998), p. 563; Baums (2002) p. 2.
21 See recommendations of the Regierungskommission Corporate Governance, 'Forward', as cited in Baums (2002), p. 12.
22 Singhof & Seiler (1998), p. 563.
23 Hirt (2004b), p. 269.
24 Buxbaum (1983), p. 513, Footnote 5.
25 Buxbaum (1983), p. 513, Footnote 5.

shareholders. As a result, shareholders, especially controlling shareholders, try to give less power to the supervisory board.

Second, the independence of members of the supervisory board has come under suspicion. This is also one of the main criticisms of German corporate governance.[26] This lack of independence may be caused by the involvement of the members of the supervisory board in management.[27] It may also be because the members of the supervisory board are so closely related to the management board that they are reluctant to file an action against the management board.[28] Moreover, the influence of the controlling shareholders on the supervisory board may prohibit the supervisory board from bringing an action with which the controlling shareholder may disagree.[29] It is normal for the supervisory board to pursue the interests of the controlling shareholders and their trustees rather than the interests of the company and all its shareholders.[30]

Third, the supervisory board lacks any incentive to enforce the corporate claim: it is short on financial, moral or reputation-oriented incentives.[31] Fourth, the operation of the supervisory board is not efficient. The board does not work on a daily basis and, in fact, its members tend only to meet quarterly.[32] It is difficult then for them to detect problems and respond efficiently. In addition, the large size of the board[33] and the codetermination system, which has caused fractionalization[34], both undermine the function of the supervisory board. Finally, the supervisory board can be used to secure personal benefits for its members.[35]

Another mechanism in the German corporate governance system, the exclusion of the voting rights of interested shareholders, is also a subject of doubt as far as its function is concerned. According to section 136 of the AktG, the shareholders against whom the decision is made may not vote, either on their own behalf or on behalf of other persons; nor may their voting rights be exercised by any other person. However, the exclusion of these voting rights is limited to the

26 Dr. Gerhard Cromme also made such a comment in his remarks on the publication of the draft German Corporate Governance Code on December 18, 2001. Other criticisms include 'an inadequate focus on shareholder interests,' 'the two-tier system of management and supervision board,' 'the inadequate transparency of German corporate governance,' and 'the limited independence of auditors.'

27 Singhof & Seiler (1998), p. 561.

28 Hirt addresses the problem as a 'residual conflict of interest.' He points out that the problem results from 'the social and institutional solidarity between members of the Vorstand and the Aufsichtsrat that are caused by the structural arrangement of the two-tier board system,' see Hirt (2004b), p. 268. For a more detailed discussion of this issue, please refer to Hirt (2004b), pp. 271-276; also see Singhof & Seiler (1998), p. 562.

29 See Hirt (2004b), p. 268, pp. 277-278.

30 Singhof & Seiler (1998), pp. 561-562.

31 Hirt (2004b), p. 268, pp. 276-277; Manchester University (1999), 'Germany', p. 29.

32 Manchester University (1999), 'Germany', p. 29.

33 The average number of members is 13.25; see Hopt (1998), at pp. 248-249.

34 Hopt (1998), at p. 247.

35 Singhof & Seiler (1998), p. 561.

disputed shareholders; other shareholders, even if they are closely related to the disputed shareholders, can still vote. Thus, the exclusion of voting rights only applies to 'the most obvious and basic conflict of interest' and therefore its function may be limited.[36] As to enforcing corporate claims, this mechanism hardly plays any role since generally in AGs the decision to assert a corporate claim against shareholders is made by the management board, and the approval of the shareholders' meeting may not be needed.

4.1.2.2 A brief history of the current reforms

The current reforms to the German corporate governance system can be traced back to the end of the 1980s and are still ongoing.[37] These reforms cover many aspects, such as company law, securities law and accounting law, with the intention of improving the German corporate governance system both by amending the traditional German explicit system of corporate control which requires direct investor influence (such as the law on the supervisory board and the law on the shareholders' meeting) and by introducing market-oriented corporate governance mechanisms (such as increasing market transparency).[38] As a result of these reforms, new legislation has been passed and quasi-legislative steps such as publishing the German corporate governance code have been taken over the past few years.[39] Indeed, these reforms are characterized as 'permanent' due to their length and intensity.[40]

As mentioned at the beginning of this chapter, the latest amendment to company law was made by the UMAG, which came into force in November 2005. This is a further important step in implementing the proposals of the Regierungskommission Corporate Governance (Government Commission on Corporate Governance). In 2000, the German Federal Chancellor started a new round of reform of company law and established a Regierungskommission Corporate Governance, chaired by Prof. Theodor Baums, to examine German company law and come up with suggestions for reform. In July 2001, the Regierungskommission Corporate Governance submitted a report containing one hundred and fifty proposals on how to improve the German corporate governance system and how to amend

36 Hirt (2004b), p. 287.
37 Noack & Zetzsche (2005).
38 Noack & Zetzsche (2005), p. 1039.
39 For a detailed discussion of the reforms, please refer to Noack & Zetzsche (2005).
40 W Zoellner, 'Aktienrecht in Permanenz – Was wird aus den Rechten des Aktionärs' (transl. The Permanent Corporate Law Reform – What happens to the rights of shareholders?) DIE AKTIENGESELLSCHAFT (1994) p. 336; U Seibert, 'Aktienrechtsreform in 'Permanenz'?' (Transl. Permanent Corporate Law Reform?) DIE AKTIENGESELLSCHAFT (2002) p. 417; as cited in Noack & Zetzsche (2005), p. 1037.

company law.[41] In February 2003 the German federal government transformed these proposals into a 'Ten-Step Program for Corporate Integrity and Investor Protection' (henceforth Ten-Step Program)[42], which was basically followed by the UMAG.

According to these proposals, three steps should be taken to accomplish this reform: first, there should be a Code of Best Practice; the second step should be an initial implementation of these recommendations into German law; and the final step should be comprehensive reform of company law.[43] These steps have been gradually carried out. In February 2002 the German Corporate Governance Code was adopted.[44] In May 2002, the German Parliament passed the Transparency and Disclosure Act which provides a legislative basis for the Code. In addition, several acts have come into force in the wake of the Ten-Step Program, including the UMAG. The UMAG revises the AktG in terms of three important aspects of corporate governance: the liability of corporate managers and the enforcement of this liability, shareholder meetings and challenging shareholder meeting resolutions.[45]

4.1.3 German rules on enforcing corporate claims

As mentioned in Section 4.1.1, AGs and GmbHs are subjected to the AktG and the GmbHG respectively, whose aspects vary in many ways. The rules on enforcing corporate claims also differ significantly with regard to these two types of companies. Therefore, I will discuss the rules for both types of companies separately. In addition, under German law groups of companies (Konzernrecht) are regulated by special rules, which are mainly embodied in Book Three of the AktG as well as in case law and jurisprudence. This special law on groups of companies also provides different rules for enforcing corporate claims on groups of companies, which I will discuss in a separate section.

4.1.3.1 The law on the AG

As in England and the United States, the proper plaintiff rule is also generally recognized in Germany. According to German law, only the injured company can

41 T. Baums (ed.), Bericht der Regierungskommission Corporate Governance: Unternehmensführung – Unternehmenskontrolle – Modernisierung des Aktienrechts (Kölon: Schmidt, 2001); For an introduction to the Report and an English version of the summary of the Recommendations, please refer to Baums (2002), Part VII.

42 Federal Secretaries of Justice and Finance, 10-Punkte-Programm der Bundesregierung zur Verbesserung der Unternehmensintegrität und des Anlegerschutzes, 25.02.2003, available at http://www.bmj.bund.de/enid/fa8a71ef4a25638be7ee184cc9d06cdd,0/ai.html; as cited in Noack & Zetzsche (2005), p. 1040.

43 Baums (2002), pp. 3-4.

44 See Supra note 12.

45 Noack & Zetzsche (2005), pp. 1041-1046.

bring an action to enforce its claims. Although the shareholders also suffer from the loss in value of shares, the loss is no more than indirect damage and the shareholders cannot bring actions directly.[46]

German law also considers the issue of who should be the appropriate body to enforce corporate claims. As in other jurisdictions, the general rule is that the pursuit of corporate claims is a business matter and should be left to the management board, which is responsible for corporate management.[47] However, German law differs from Anglo-American law in cases where the management board has a conflict of interest in making litigation decisions. Under German law, where the corporate claim is against a member of the management board, it is the supervisory board that decides whether to pursue a corporate suit. The supervisory board not only has the right but also the duty to do so.[48] As mentioned, German company law is based on the two-tier structure and the main function of the supervisory board is to supervise the management board, which includes bringing an action against the members of the management board when necessary. This approach is based on the understanding that the management board will not bring claims against its own members.

However, as mentioned in Section 4.1.2.1, the function of the supervisory board, including the function of enforcing corporate claims against the managing directors, is open to debate. It is possible that the supervisory board will unduly refuse to enforce corporate claims in certain circumstances, especially against their colleagues. As a result the issue then arises as to whether minority shareholders should be given the power to enforce corporate claims. As we know, German law on this issue has experienced a great many changes since the implementation of the UMAG. Therefore, I will discuss the rules before and after the UMAG separately.

Prior to the UMAG

In contrast to the relatively pragmatic approach in common law jurisdictions where an exception to the proper plaintiff rule for derivative actions has been

46 Section 117 (1), AktG. Also see Singhof & Seiler (1998), p. 554.

47 AktG section 78(1) states that 'the management board shall represent the company in and out of court'.

48 AktG section 112 provides that: 'the supervisory board shall represent the company both in and out of court as against the members of the management board.' In the case of *ARAG/Garmenbeck* (BGHZ 135, 244, pp. 249-250 and pp. 252-253) 1997, the Federal Supreme Court (Bundesgerichtshof) clearly held that the supervisory board not only has the right but the duty, based on its discretion, to decide and pursue claims against members of the management board in certain circumstances; before this case the supervisory board's duty to enforce such a claim was still uncertain. Nevertheless, the Supreme Court did not consider further what to do if the supervisory board failed to perform its duty. See Hirt (2004b), pp. 262-266.

allowed[49], the German approach prior to the UMAG was extremely literal and strict. Under previous German law, minority shareholders could not enforce corporate claims in their own names except within groups of companies, even if the claims were aimed at wrongdoing directors.[50] Therefore, strictly speaking the common law sense of the derivative action generally did not exist in Germany. Nevertheless, the previous German law did recognize the possibility that the injured company could not seek remedies by itself where there was conflict of interest. Therefore, in order to protect the interests of the company and the minority shareholders, the previous German law, in section 147 of the AktG (1998)[51], granted a group of minority shareholders the right to force the company to bring a corporate claim.[52] According to this section, the minority shareholders still could not bring an action on behalf of the company in their own names, rather, the action had to be brought in the name of the company by the corporate bodies or the special representatives appointed by the court.[53] Nevertheless, the minority shareholders' right under section 147 of the AktG (1998) ended up playing the same role as the derivative action in the sense that it also provided minority shareholders with the right to enforce corporate claims and discipline the wrongdoers, and therefore was basically analogous to common law derivative actions.

The UMAG

Since section 147 of the AktG (1998) did not perform its role satisfactorily, reform was suggested and then implemented in the UMAG.[54] The UMAG changes section 147 of the AktG (1998) significantly. It amends section 147 and inserts a new section 148 of the AktG which allows a shareholders' derivative action in the common law sense. In other words, according to this amendment, a group of minority shareholders, as long as they meet the requirements stated in the section, can enforce corporate claims in their own names. More significantly, the UMAG amends the requirements for the minority shareholders when enforcing such a right.[55] For example, it considerably lowers the standing threshold for minority shareholders to bring such an action and grants more power to the court so that it can balance corporate efficiency with the interests of the company and of minority shareholders.

49 Singhof & Seiler (1998), p. 553.
50 For the rules regarding groups of companies, see Section 4.1.3.3.
51 The last revision of section 147 of the AktG before the UMAG was made in 1998; therefore, I refer to it as 'the AktG (1998)' in this book.
52 For a detailed discussion on the section, please refer to Section 4.4.1.
53 For more details, see Section 4.4.1.
54 For a detailed discussion of the reasons behind this, see Section 4.4.2.1.
55 For a detailed discussion of the amendments, please refer to Section 4.4.2.

4.1.3.2 The law on the GmbH

Both the principle of proper plaintiff rule and the principle that shareholders cannot claim for reflective losses directly have also been accepted into the GmbH law. Moreover, as in the AG, generally the management board or the managing director in the GmbH has the power to enforce corporate claims.[56] Where the corporate claim is against corporate directors, shareholders via a resolution of the shareholders' meeting can decide whether to initiate an action against the directors and may pursue this action in the name of the company.[57] Nevertheless, in large GmbHs, where a supervisory board is compulsory, it is the supervisory board that enforces corporate claims against the members of the management board.[58] In addition, shareholders in the GmbH via the resolution of the shareholders' meeting can also enforce corporate claims against a shareholder[59], provided that 'the shareholder against whom it is proposed to bring an action has no right to vote in that case'.[60]

There is no provision in the GmbHG equivalent to sections 147 and 148 of the AktG (the UMAG), which grants minority shareholders the right to bring derivative actions. However, in recent years German case law has developed the so-called right of *actio pro socio* (or *actio pro societate*), which grants individual shareholders of the GmbH the right to enforce corporate claims against fellow shareholders of the company in his own name, provided that the shareholders' meeting has already decided not to pursue these corporate claims (with the accused shareholders unable to vote regarding the decision[61]) and that the decision not to sue has constituted a breach of the duty of loyalty by the shareholders who made the decision.[62] The remedies in the *actio pro socio* go to the company directly rather than to the individual plaintiff shareholders.[63]

Although it is debatable, the prevailing view is that an individual shareholder cannot apply the right of *actio pro socio* to enforce corporate claims against directors or third parties.[64] The claims to such a right are limited to those arising from the relationship between shareholders, such as the payment of contributions

56 GmbHG section 35(1).

57 GmbHG section 46(8).

58 GmbHG section 52(1).

59 GmbHG section 46(8).

60 GmbHG section 47(4).

61 GmbHG section 47(4). For a detailed discussion of the restriction on the interested shareholder's voting rights, see Section 4.2.3.2.

62 Kleindiek (1993), at p. 144; Stecher (1997a), p. 94.

63 Stecher (1997a), p. 94.

64 For example, Baums holds that there is no right of action against the managing directors for single shareholders or for a minority in the limited liability company; Baums (1996), p. 322. Baums refers to Bundesgerichtshof, 28 June 1982, Wertpapier-Mitteilungen 1982, p. 928 for his conclusion; see Baums(1996), p. 322, Footnote 41. Also see Stecher (1997a), p. 94; Kleindiek (1993), at p. 144.

on shares that are already due and the termination of unfair competition by a fellow shareholder.[65] Due to the limitations mentioned above, the right of *actio pro socio* under German law is generally regarded as being different from the right to derivative action. Hopt regards the right of *actio pro socio* as a 'subspecies of the derivative action'.[66] In fact, he considers that the unique character of the *actio pro socio* lies in that 'it has its basis in membership', therefore, it is more correctly regarded as a personal right of the shareholder rather than a right to derivative action.[67] For the same reason, I will not treat the right of *actio pro socio* as a derivative action either and will not be including it in my discussion of the minority shareholders' right to enforce corporate claims under German law.

4.1.3.3 The law on groups of companies

As mentioned, groups of companies in Germany are subject to specific rules. The German law distinguishes three kinds of groups of companies: those where a control agreement exists[68], those where no control agreement exists but a controlled company may be harmed[69], and those where an integrated contract exists.[70]

In groups of companies, an individual shareholder of a controlled company can in his own name assert claims for the company for damages against the controlling enterprise, against the legal representatives of the controlling enterprise, or against the members of the management board and the supervisory board of the controlled company in certain circumstances.[71] In this action, the plaintiff shareholder can 'only demand that compensation be paid directly to the company…'.[72] Although the majority opinion regards this individual shareholder's right under section 309(4) as a right to derivative action[73], a minority has submitted that it is actually similar to an *actio pro socio* and therefore that it should be treated as a personal right of the shareholder.[74]

65 Stecher (1997a), p. 94.
66 Hopt (1997), pp. 272-273.
67 Hopt (1997), pp. 272-273.
68 Sections 308-310 of the AktG.
69 Sections 311-318 of the AktG.
70 Sections 319-327 of the AktG.
71 Sections 309, 310, 317, 318 and 323 of the AktG. For the limited application, see next paragraph.
72 Section 309(4) of the AktG.
73 This individual shareholder's right is first provided in section 309(4) of the AktG and therefore will be referred to as the right under section 309(4) hereinafter.
74 Hopt (1997), p. 279.

The right under section 309(4) hardly has significance in practice. In fact, it seems that the right has never been exercised since it was introduced.[75] Hirt identified two reasons for the practical insignificance of section 309(4).[76] The first reason is that the application of the right is rather limited.[77] For example, in the case of groups of companies where a control agreement exist, the minority shareholder's right under section 309(4) may only apply to cases where the legal representatives of the controlling enterprises, in issuing instructions to the controlled company, violate their duty and cause damage to the controlled company.[78] The second reason pointed out by Hirt concerns the allocation of costs: although the compensation should be paid to the company, the individual shareholder, who initiated the action in his own name, bears the litigation costs, and there is no obligation for the company to indemnify the plaintiff shareholder. Therefore, an individual shareholder has no incentive to initiate such an action.[79] In addition, there is a third reason that the difficulty in obtaining information may also frustrate an individual shareholder in initiating such an action. Because of the insignificance of the shareholder's right of derivative action in groups of companies, I will not discuss the right in detail here.[80]

4.2 The role of the minority shareholders' right to enforce corporate claims in Germany

4.2.1 The unimportant role of the minority shareholders' right to enforce corporate claims in German corporate governance

Generally speaking, the minority shareholders' rights to enforce corporate claims have played an unimportant role in German practice. As will be seen in Section 4.4.1, the scope of section 147 of the AktG (1998) was limited: it was intended to grant minority shareholders the right to cause corporate claims against board members to be enforced rather than to be used against controlling shareholders. Moreover, this right has hardly ever been exercised in practice. The pertinent sections in the AktG were regarded as 'dead letters'.[81] Hermann Abs, former CEO of Deutsche Bank AG, quipped that 'It is easier to grab a pig at its soapy tail than to hold the manager of a German corporation liable'.[82] In fact, although under German law the standard of the duty owed by directors is high, the general enforcement of the directors' duty, not only by minority shareholders, but also by

75 Hirt (2004b), p. 310; Kraakman et al. (2004), p. 125.
76 Hirt (2004b), pp. 314-315.
77 Hirt (2004b), p. 314.
78 Sections 309(1) and 310 of the AktG. See Hirt (2004b), p. 314.
79 Hirt (2004b), pp. 314-315.
80 Hirt (2004b), p. 315, Footnote 220.
81 See Singhof & Seiler (1998), p. 558.
82 See Singhof & Seiler (1998), p. 558, Footnote 269.

the company, is poor in Germany. Under German law directors are under the obligation to act 'with the care of a diligent and conscientious manager'.[83] This is an objective standard. A director may not discharge his duty by acting only with the care that would be exercised in his own affairs. Therefore, it is a comparatively high standard.[84] However, there are only a few court decisions on enforcing the directors' duty, and most of them deal with two specific situations: one is when the company is bankrupt and the trustee of the bankrupt company sues the former directors of the company; the other is when by suing the former director the company defends itself against claims by a former director for his pension claims or payments.[85] A statistic from an insurance company showed that ninety percent of all disputes between directors and companies were settled outside the courtroom.[86]

In the GmbH, which is the most common type of company in Germany, minority shareholders simply have no exact equivalent to section 147 of the AktG. Therefore, they cannot cause corporate claims against board members and/or third parties to be enforced. Although they can enforce corporate claims against fellow shareholders via the *actio pro socio*, the application of such a right is rather limited due to the restrictions imposed on this right.

4.2.2 The reasons behind this unimportant role

The most important reason behind the unimportant role of the minority shareholders' right to enforce corporate claims is the restricted scope of the right and the stringent requirements for applying the right in the AktG (1998). The high thresholds established by section 147 of the AktG (1998) are generally regarded as being too stringent to overcome and the allocation of litigation costs has proved a negative incentive for those minority shareholders who might have exercised this right.[87] In addition, it is difficult for minority shareholders to obtain information that is needed to pursue such a case; this has especially been the case for minority shareholders who wanted to initiate the assertion of a corporate action according to section 147(3) of the AktG (1998) because they might not have the right to require a special audit. Such a special audit is carried out by an expert under the control of the court who audits the management of the AG and therefore supplements the information right of shareholders.[88] Under section

83 AktG sections 93(1) and 116; GmbH section 43(1).

84 See Singhof & Seiler (1998), pp. 550-553; Baums (1996), at p. 321.

85 Baums (1996), at p. 319. This is also the situation with the members of a supervisory board; see Theisen (1998), at pp. 263-264.

86 Chubb Insurance Co. of Europe SA, Düsseldorf, 'Managerhaftung' (1993), at 3; as cited in Baums (1996), at p. 319, Footnote 8.

87 For a detailed discussion of the requirements and allocation of costs under section 147 of the AktG (1998), see Section 4.4.

88 For a more detailed discussion on the right to a special audit, see Section 4.2.3.1.1.

147(3) of the AktG (1998) the capital threshold for minority shareholders to exercise the right was five percent, however, according to section 142(2) of the AktG (1998), only shareholders 'whose aggregate holdings equal or exceed one-tenth of the share capital or the *pro rata* amount of EUR 1 million' could apply for the appointment of special auditors. The obstacles in section 147 of the AktG (1998) to the minority shareholders' right to enforce corporate claims were widely recognized and therefore the UMAG has significantly changed the old rules, which I will discuss in Section 4.4 in detail. However, whether the changes in the UMAG will encourage minority shareholders to enforce corporate claims in practice remains to be seen.

Another reason for the unimportant role of the minority shareholders' right to enforce corporate claims is that German company law contains a wide range of alternative mechanisms for protecting the interests of the company and the minority shareholders and for disciplining corporate management. I will discuss these later.

This unimportant role may further be explained by the traditional German attitude towards minority shareholder protection and corporate management. First of all, as mentioned in Section 4.1.1, the German 'stakeholder' culture and the lack of mature capital markets in Germany result in less attention being paid to minority shareholder protection. Second, traditionally directors are trusted in Germany[89], at least partly due to the successful economy in years past.[90] Last, and perhaps most important, with regard to the conflict between the efficiency of corporate management and the protection of the interests of the company and the shareholders, German law traditionally favors the former. Minority shareholders' litigation is usually not trusted under German law[91], at least partly due to the existence of many abusive shareholder suits, such as the strike suits used to set aside the resolutions of the general meeting.[92] Under German law, thresholds for minority shareholders to enforce corporate claims are high, class actions are generally unknown[93], and shareholders almost have no right to bring a direct action to challenge the board's decision even if it has violated the constitution of the company.[94] When considering the requirements for the minority shareholders' right to enforce corporate claims, generations of legislators, from 1884, when the antecedent of the current section 147 was enacted, until now, have worried about the risk that the minority shareholders' right to enforce corporate claims would lead to unjust intervention in corporate management and generally discourage

89 Kraakman et al. (2004), pp. 129-130.

90 See Singhof & Seiler (1998), p. 563.

91 Singhof & Seiler (1998), p. 563; Herbert Wiedemann, Organverantwortung und Gesellschafterklagen 49 (1989), p. 42; as cited in Singhof & Seiler (1998), p. 562.

92 Hopt (1997), pp. 267-268.

93 Singhof & Seiler (1998), p. 555.

94 For a detailed discussion, see Section 4.3.1.

directors' enthusiasm.[95] Thus, German law has always had a less positive attitude towards shareholder litigation. Lawyers, even those who admit that shareholder litigation should play a more important role, regard it as a necessary but only a subsidiary mechanism.[96] Shareholder litigation is unlikely ever to be in the forefront of German corporate governance.

4.2.3 The alternative mechanisms in German corporate governance

As mentioned above, the mechanisms applied to protect the rights of the company and the shareholders vary according to the type of company. Therefore, I will discuss the major mechanisms regarding the AG and the GmbH separately.

4.2.3.1 In the AG

Both the conflict between majority shareholders and minority shareholders and the conflict between shareholders and directors may exist in German AGs. Therefore, the AG and shareholders may face the risk of being harmed by majority shareholders and/or directors.[97] Nevertheless, the main mechanisms dealing with these two agency problems under German law are not always identical.

4.2.3.1.1 Alternative mechanisms against the directors' abuse of power in the AG

The regulations of the AktG reflect the fact that conflict between shareholders and directors is a major concern for the legislature. The reason is that in the AG the management board is exclusively responsible for corporate management and enjoys great freedom in the exercise of its authority.[98] There is no hierarchy within the company's three bodies: the general meeting of shareholders, the management board and the supervisory board. In addition, directors cannot be removed without cause[99] and therefore, in practice, it is very difficult to remove a director from the board.[100]

German law has provided a wide range of legal mechanisms for disciplining corporate management and protecting the interests of the company and shareholders. In addition to the mechanism of charging directors with liability[101] and

95 See Hirt (2004b), pp. 280-281, pp. 318-320.
96 See, for example, Hirt (2004b), p. 279.
97 See Hirt (2004b), p. 257.
98 Section 76(1) of the AktG states that: 'The management board shall have direct responsibility for the management of the company.' Also see Kleindiek (1993), at pp. 138-139.
99 See 84(3) of the AktG.
100 Chantayan (2002), pp. 439-440.
101 Section 93 of the AktG.

awarding the shareholders, either collectively or in a small group, the right to enforce that liability[102], there are two other mechanisms that deserve attention. The first mechanism, which is also regarded as the most important one, is the two-tier system which provides a well-organized system of checks and balances. Under German law, a supervisory board is compulsory in the AG in order to supervise the operation of the management board *ex ante* and enforce directors' liabilities *ex post* if there has been a breach of duty by directors. This is the major mechanism under German law for disciplining corporate management: the *ex ante* supervision of the supervisory board can reduce the risk of directors' breach of duty, and the *ex post* enforcement can redress the loss caused by that breach. Although there are more and more doubts about the role of the supervisory board[103], the traditional belief is that the German two-tier system has worked effectively and that the supervisory board has generally served its supervisory function in preventing directors' breach of duties. This has contributed to the success of the German economy in the past.[104] This perceived effectiveness of the supervisory board partly explains why the role of the derivative action has been generally neglected both in statutes and in practice.

The second mechanism is the shareholders' right to a special audit.[105] According to the right to a special audit, shareholders have the right to 'appoint special auditors for the examination of matters relating to the formation of the company or the management of the company's business, and also, in particular in connection with capital increases or capital reductions'.[106] This right can be exercised by a simple majority of shareholders.[107] In addition, a group of minority shareholders[108] can also apply to the court for such a special audit, 'provided that facts exist which give reason to suspect that improprieties or gross violations of law or the articles have occurred in connection with such matter'.[109] Such a right can also be exercised by an individual shareholder of a dependent company within a group of companies in order 'to audit the business relations of the company with its controlling enterprise or an enterprise affiliated with such controlling enterprise…'.[110] Although the right to a special audit is not widely used, the general consensus is that it has a deterrent function.[111]

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102 Section 147 of the AktG (1998), sections 147 and 148 of the AktG (the UMAG).

103 For these doubts see Section 4.1.2.1.

104 See Singhof & Seiler (1998), p. 561, p. 563.

105 Section 142 of the AktG.

106 Section 142(1) of the AktG.

107 Section 142(1) of the AktG.

108 Section 142(2) of the AktG (1998) required that shareholders aggregately hold an amount equal to or more than one-tenth of the share capital or a *pro rata* amount of EUR 1 million in order to apply this right. However, the threshold has been reduced by the UMAG to one percent of the share capital or the *pro rata* amount of EUR 100,000.

109 Section 142(2) of the AktG.

110 Section 315 of the AktG.

111 Hopt (1997), p. 280.

4.2.3.1.2 Alternative mechanisms against the majority shareholders' abuse of power in the AG

In AGs the conflict between majority and minority shareholders, which may lead to injury to the company and/or to the minority shareholders, can also exist. Nevertheless, section 147 of the AktG was not aimed at disciplining majority shareholders.[112] Rather, German law has developed several alternative mechanisms for controlling the majority shareholders' conduct. First of all, the governing power of the majority shareholders has been restricted. In the AG the general meeting has hardly any influence on corporate management. Rather, directors are solely responsible for the management of the company.[113] In addition, shareolders have no right to ratify directors' misconduct retrospectively[114], and they can only waive or compromise corporate claims against the directors 'upon the expiry of three years after the claim has arisen' and 'no minority whose aggregate holding equals or exceeds one-tenth of the share capital records an objection in the minutes'.[115] As we know, the majority shareholders may abuse their power via either the general meeting or the board of directors. By limiting the power of the general meeting, the majority shareholders' abuse via the general meeting can be restricted.[116]

Second, the prevention of the interested shareholder from voting may minimize the risk of conflict of interest and so play an important role in preventing the shareholders' abuse of power. Section 136(1) of the AktG provides that:

> No person may exercise voting rights on his own behalf or on behalf of any other person in respect of a resolution concerning ratification of his acts, his discharge from a liability, or enforcement by the company of a claim against him. Voting rights arising from shares which may not be exercised by the shareholder himself pursuant to sentence 1 may also not be exercised by any other person.

As will be seen, this restriction is also laid down in the GmbHG.[117]

Third, according to section 241 *et seq.* of the AktG, an individual shareholder in the AG, no matter how many shares he owns[118], has the right to bring actions to set aside defective resolutions of shareholders' meetings within one month

112 But the UMAG changes the approach. For details see Section 4.4.

113 Bröhmer (2000), p. 59.

114 See section 120 of the AktG.

115 See section 93(4) of the AktG.

116 The possible abuse of power by the majority shareholders via the board is generally treated as an agency problem of directors.

117 See Section 4.2.3.2.1.

118 Section 245 of the AktG.

after adoption of those resolutions.[119] This right is regarded as particularly important for minority shareholders in the AG[120], especially considering that several important measures, such as the alteration of the articles of association, the distribution of dividends, and corporate restructuring methods, need resolutions by shareholders' meetings. For a detailed discussion of the right, please refer to Section 4.3.1.

Fourth, shareholders owe a duty of loyalty (Treuepflicht) to the company and other shareholders, which is a characteristic of German law.[121] For AGs this duty was recognized later than it was for GmbHs. Although there is a running controversy about the contents of this duty, it is generally recognized that the extent of the duty varies in different situations: the more influence the shareholder may have on the management, the greater the extent of the duty owed by that shareholder to the company and other shareholders.[122] As a result, in AGs the company or an individual shareholder may bring actions against the controlling shareholder for his breach of fiduciary duty owed to either of them.

Fifth, the principle of equal treatment of shareholders also provides protection for minority shareholders.[123] This principle is regarded as a special aspect of the shareholder's duty of loyalty.[124]

Last but not least, we should bear in mind that German law on groups of companies (Konzernrecht) also plays an important role in regulating the conduct of the controlling shareholders of an AG. This approach is different from the Anglo-American approach. Under both English and American law, there is no specific law on groups of companies. The group problems are mainly regulated by the same rules as those regulating a single company. German law treats group relationships differently from the relationship between a mere dominating shareholder and the company. The reason is that if the dominating shareholder is not merely a shareholder, but also pursues business interests in another AG or other type of business, there is a greater risk that he will not act in the interests of the dominated company. The interests of the dominated company may be subordinated to the interests of his other business ventures. This specific law on groups of companies is also a feature of German law.

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119 Section 246(1) of the AktG.

120 Stecher (1997a), p. 94.

121 In *Linotype,* BGHZ 103, 184 (1988), at p.194, the Federal Supreme Court held that '[a] legal duty of loyalty also exists between the shareholders of a stock corporation'; as cited in Kleindiek (1993), at p. 142. Also see Hirt (2003c), pp. 525-526.

122 Kleindiek (1993), at p. 142.

123 Section 53(a) of the AktG provides that 'shareholders should be treated equally under equivalent circumstances.'

124 Stecher (1997a), p. 97.

4.2.3.2 In the GmbH

4.2.3.2.1 Against the controlling shareholders

The main agency problem in the GmbH is the controlling shareholders' influence on corporate management. Usually it is the controlling shareholders rather than the directors who control the management of the company. In the GmbH, the shareholders' meeting has superior authority over the management board or managing representatives. Shareholders have the right to appoint the managing directors and can remove them at any time without restrictions[125]; the right of shareholders to be involved in corporate management can be freely structured in the contract[126]; shareholders have the right to decide on the guidelines of company policy[127]; the managing directors must obey the instructions of shareholders[128]; and, in practice, directors usually ask for shareholders' consent for management decisions.[129]

Few provisions in the GmbHG against the controlling shareholders

The GmbHG contains only a few provisions aimed at protecting the company and minority shareholders from the controlling shareholders' abusive use of power. The legislature's consideration is that the GmbH is the proper legal vehicle for business organizations which are less complex and more flexible. The shareholders in the GmbH are presumed to have a closer relationship with each other than the shareholders of an AG. As a result, the regulations in the GmbHG are deliberately minimized and optional. Shareholders are supposed to protect themselves through provisions in the articles of association.[130]

Restrictions on the interested shareholders' right to vote

Like that in the AktG, an important regulation in the GmbHG, which may prevent the controlling shareholders' abuse of power, is the restriction on the shareholders' right to vote.[131] Section 47(4) of the GmbHG holds that if a decision concerns a waiver of a shareholder's liability or obligation, concerns a transaction between a shareholder and the company, or concerns a decision to sue a shareholder or to seek for other legal solution for the dispute, the shareholder against whom the decision is made cannot vote.

125 Sections 38(1), 46(5) of the GmbHG.
126 Section 45(1) of the GmbHG.
127 Section 46 of the GmbHG.
128 Section 37 (1) of the GmbHG.
129 Kleindiek (1993), at p. 139.
130 Kleindiek (1993), at p. 139.
131 The GmbHG also provides for the minority shareholders' right to call a general meeting (s 50 (1)) and the shareholders' right to information (s 51a).

The shareholder's duty of loyalty owed to the company and to fellow shareholders

German case law has developed other important mechanisms for regulating the conduct of shareholders. According to German law, shareholders, both majority and minority shareholders, owe a wide duty of loyalty (Treuepflicht) to the company as well as to other shareholders.[132] Two reasons may account for the imposition of such a duty. First, there is a greater degree of cooperation and personal trust in GmbHs: 'the relationships between a shareholder in the GmbH and his fellows are not purely capitalist, but also personal'.[133] Second, the controlling shareholders have a greater influence on corporate management and there is a greater possibility for them to use this influence. As a result, the power to exercise influence on corporate management and other shareholders' interests has to be balanced by a legal obligation to consider the interests of the company and other shareholders.[134]

The contents and scope of the shareholder's duty of loyalty depend on individual circumstances; factors such as the nature of the relationship among shareholders, the scope of investment, the duration of the investment and the effect of an action on other shareholders will be considered when deciding the shareholder's duty of loyalty.[135] Examples of the shareholder's breach of this duty in the GmbH include making efforts to dissolve the company so that other shareholders cannot continue their business,[136] refusing to join a necessary capital increase due to his own interests,[137] and unfairly competing against the company through another company by exercising an influence on the management of the first company.[138]

The controlling shareholder's breach of the duty of loyalty may give rise to either corporate claims or shareholders' personal claims against them, which I will discuss in Section 4.3.3.

132 For a detailed discussion of the shareholders' duty of loyalty, see Kleindiek (1993), pp. 138-147.

133 Scogin (1993), p. 182.

134 Kleindiek (1993), at p. 141. In the *ITT* case, the German Federal Supreme Court stated that: 'The possibility for the majority of shareholders to exercise influence on the management and therefore to interfere with the business interests of the other shareholders requires as a counterpart the legal obligation to consider these interests.' See *ITT* BGHZ, 65, 15, (1975) at p. 19; as cited in Kleindiek (1993), at p. 141.

135 Stecher (1997a), pp. 96-97.

136 BGHZ 76, 352, 355 f; BGH NJW 1985, 1901; as cited in Stecher (1997a), p. 97.

137 BGH WM 1987, 841; as cited in Stecher (1997a), p. 97.

138 BGHZ 80, 69, p. 74; as cited in Stecher (1997a), p. 97.

The remedies of dissolution, withdrawal and expulsion

German law concerning the GmbH also protects shareholders by providing them with highly discretionary remedies. Section 61 of the GmbHG grants shareholders the remedy of dissolution. It provides that:

> The company may be dissolved by a court decision in case it becomes impossible to accomplish the purpose of the company or when there are other substantial causes (wichtige Grund) for the dissolution resulting from the conditions of the company.[139]

Here these substantial causes focus on the circumstances of the company rather than on the individual shareholders.[140]

Since the dissolution remedy is very harsh and since there is no other solution in the GmbHG, German case law has developed two additional remedies, the withdrawal (Austritt) and the expulsion (Ausschliessung), to protect shareholders. Neither of these remedies may be restricted or excluded by the articles of associations.[141] With the remedy of withdrawal, the aggrieved shareholders can exit the GmbH and are entitled to obtain the fair market value of their interests in the GmbH.[142] This is important for the shareholders because of the illiquidity of shares in the GmbH. However, German law is silent about whether the aggrieved shareholders can be compensated for their reflective losses through the remedy of withdrawal where the basis for the relief is, at least partly, an injury to the company. On the other hand, the remedy of expulsion provides a good solution for those aggrieved shareholders who want to stay in the GmbH rather than withdraw.[143] Normally the expelled shareholders will not be fully compensated because the German courts generally value companies conservatively.[144] Under German case law, even the majority shareholder may be expelled from the company.[145] The reason this becomes possible is that, although the expulsion of a shareholder needs a shareholders' resolution, the expelled shareholder is not allowed to vote with his own shares.[146] Therefore, it is possible that a majority shareholder may be expelled from the company by minority shareholders.[147] This

139 Section 61 of the GmbHG.
140 Scogin (1993), p. 134.
141 Scogin (1993), p. 155 and p. 157.
142 Kleindiek (1993), at pp. 144-145; Miller (1997), p. 396.
143 Miller (1997), p. 396.
144 Scogin (1993), p. 179.
145 Kleindiek (1993), at pp. 141-142. For a detailed discussion on the withdrawal and expulsion, see, for example, Scogin (1993); and Miller (1997).
146 Scogin (1993), p. 157.
147 Judgment of Apr. 1, 1953, BGHZ, 9, 178; as cited in Scogin (1993), p. 157.

risk of expulsion from the company plays an effective role in disciplining the controlling shareholder's behavior.[148]

A substantial basis (wichtige Grund) has to be established in order for the shareholder to be awarded the remedy of withdrawal or expulsion.[149] However, unlike the focus on the circumstances of the company found in the remedy of dissolution, these two remedies focus on the personal aspects of the relationships between shareholders.[150] In the withdrawal remedy, there can be three sources for this substantial basis. The first one involves the exit shareholder personally, such as his financial situation or health; the second involves the behavior of other shareholders, such as the majority shareholders' abuse of power; while the third involves a situation such as the changed purpose of the company.[151] In the expulsion remedy, the sources for the substantial basis are narrower than those in the withdrawal remedy since the expulsion is against the will of the expelled shareholders; the substantial basis here must involve the expelled shareholder, such as his age, illness, or financial circumstances or behavior.[152] In either remedy, the substantial basis requires no element of fault and its broad but vague definition gives the court wide discretion in using it to solve disputes among shareholders.[153]

The individual shareholder's right to challenge defective resolutions of shareholders' meetings

As mentioned, an individual shareholder in AGs has the right to initiate claims against defective resolutions of the shareholders' meeting. German courts also apply this right to shareholders in GmbHs by analogy but there are special circumstances which can make the application in the GmbH inappropriate.[154]

4.2.3.2.2 Against the directors

As to the conflict between shareholders and directors, normally the shareholders via the resolutions of the general meeting have the power to discipline the conduct of the directors both *ex ante* and *ex post*. Nevertheless, minority shareholders, either as a group or individually, may not enforce corporate claims against the directors.

148 Scogin (1993), p. 179.
149 Scogin (1993), p. 135.
150 Scogin (1993), pp. 134-135; Miller (1997), p. 396.
151 Scogin (1993), p. 155.
152 Scogin (1993), p. 160.
153 Scogin (1993), p. 135.
154 Kleindiek (1993), pp. 143-144; Stecher (1997a), p. 95. For more details see Lutter and Hommelhoff, GmbH-Gesetz, Cologne, 1991 (13th edn), annex paragraph 47; Raiser in Hachenburg, GmbH-Gesetz, Berlin, 1991 (8th edn); Raiser, 'Nichtigkeits- und Anfechtungsklagen', in Festschrift 100 Jahre GmbH-Gesetz, Cologne, 1992, at p. 587 onward.

4.3 The proper plaintiff principle: the distinction between corporate action and shareholders' direct action

4.3.1 Claims to set aside defective resolutions of corporate bodies

German law takes different approaches towards the individual shareholder's right to directly bring claims to set aside defective resolutions of the board of directors and the right to set aside defective resolutions of shareholders' meetings.

Claims to set aside defective resolutions of the board of directors

Under German company law the general principle is that directors owe the duty to 'employ the care of a diligent and conscientious manager' to the company rather than to individual shareholders.[155] There is no direct relationship between directors and individual shareholders. As a result, the breach of duties by directors only gives rise to corporate claims and an individual shareholder cannot challenge directors' management decisions. This principle is very strict under German law. An individual shareholder is not only unable to bring direct claims against the breach of directors' duties for corporate damages, but is also unable to bring direct claims to prevent the execution of a board's decision, even if the board's decision was illegal or violated the constitution of the company. The right to challenge the board's decision belongs only to the company.[156] This approach differs from the English and American approach. Under English or American law, although in principal directors also owe fiduciary duties to the company rather than shareholders, an individual shareholder still can bring a direct action to restrain an illegal act or an act which has violated the constitution of the company: the constitution is regarded as a contract between the shareholders and the company, any violation of which may give rise to a shareholder's direct action to enforce it.

However, German case law recently moved a step towards the common law trend and recognized the individual shareholder's right to interfere with corporate management in a limited number of situations. In the case of *Holzmüller*, the German Supreme Court held that an individual shareholder could challenge the board's decision if the decision made by the board was not within the board's power but required a decision by the shareholders' meeting.[157] Nevertheless, the UMAG does not make any change to the minority shareholder's right to set aside defective decisions of the board of directors.

155 Sections 93 of AktG and section 43 of the GmbHZ.

156 Kleindiek (1993), at p. 144.

157 Decision of BGH, 25 Feb. 1982, repr. in 37 Juristenzeitung [JZ] 602, (1982). See Buxbaum (1983), where the case is referred to as the '*Müller*' case.

Claims to set aside defective resolutions of shareholders' meetings

Unlike the strict approach towards the individual shareholder's right to bring claims to set aside defective board decisions, German law takes a very lenient approach towards the shareholder's right to bring direct actions to set aside the resolutions of shareholders' meetings. This right is regulated in the AktG, but it is also applied to the GmbH by analogy except where there are special circumstances that make the application in the GmbH inappropriate.[158]

According to the AktG, the shareholders' resolutions may be void *per se* or voidable. Void resolutions include, for example, those resolutions adopted in a shareholders' meeting which was called in violation of the legal requirements, or those resolutions that are not compatible with the nature of the company or that violate provisions for the protection of creditors of the company.[159] Voidable resolutions include those in violation of law or the articles of the company[160], or those attempting to serve the purpose of a single shareholder in order to obtain special benefits for himself or another person to the detriment of the company or other shareholders, unless other shareholders are adequately compensated for their losses.[161] A voidable resolution is initially valid but may be set aside by an action brought by an individual shareholder, the management board, or any member of the management board or supervisory board.[162] The action must be brought against the company.[163]

The individual shareholder's right to bring direct actions to set aside defective shareholders' resolutions under German law is very broad. According to the AktG, in addition to the right to set aside illegal resolutions or resolutions violating the articles, the individual shareholder may bring a claim to set aside a resolution which tries to obtain unfair special benefits for the controlling shareholder.[164] In fact, this right is of utmost importance in Germany. Many actions to set aside resolutions have been brought on grounds such as insufficient disclosure, the controlling shareholder's breach of duty of loyalty or the breach of the principle of equal treatment.[165]

However, there is a risk that the individual shareholder's right to challenge the defective resolutions of shareholders' meetings may unjustly interfere with corporate management since the action will prevent implementation of the challenged resolution.[166] Such an action may take up to four to five years if the

158 Kleindiek (1993), pp. 143-144.
159 Section 241 of the AktG.
160 Section 243(1) of the AktG.
161 Section 243(2) of the AktG.
162 Section 245 of the AktG.
163 Section 246 (2) of the AktG.
164 Section 243 of the AktG.
165 Hopt (2004), p. 408.
166 Günther & Roth (2006); Noack & Zetzsche (2005), pp. 1044-1045.

case goes to the Federal Court of Justice (Bundesgerichthof).[167] The business opportunities of the company simply cannot be put on hold for so long a period of time. This risk is especially real since such a right has in fact been broadly abused in German practice, especially where it concerns the directors' duty of information to shareholders.[168] According to section 131 of the AktG, an individual shareholder can request any information that is related to his voting right in the shareholders' meeting and, if unjustly denied, bring an action to challenge the resolutions made in the meeting. This right has been abused especially by 'professional minority shareholders,' who buy very few shares in almost all listed companies and attend shareholders' meetings in order to settle with the company in return for hush money.[169] In fact, the abuse of the right and its fatal effect on a company is regarded as 'a unique situation in Europe'.[170]

The UMAG is intent on changing this situation and has imposed new restrictions on this right. For example, in order to reduce the burden on management to answer questions raised by shareholders and to prevent strike suits based on insufficient information, the UMAG has made the provision that any information, which has been published on the corporate website at least seven days before the start of the shareholders' meeting and is constantly accessible during the meeting, is considered to be given in the shareholders' meeting.[171] In addition to this, it has provided that if an action to set aside any shareholders' resolutions is based on insufficient information, such information should be considered by an objective shareholder as being essential for the exercise of his voting right.[172] The UMAG has also prevented a shareholder from bringing such an action if the action is based on insufficient information about the value of the company, when these matters can be settled in a special evaluation procedure (Spruchverfahren).[173] In order to prevent strike suits generally, the UMAG has also provided a new preliminary procedure, by which Regional Courts will decide whether the corporate management can execute the resolutions within four months of the meeting.[174] If the resolutions, according to the court's decision, can be implemented but afterward are found defective, the effect of the resolutions will not be affected but the shareholder will be compensated.[175] Therefore, the action's influence on corporate management is greatly reduced.

167 Günther & Roth (2006); Noack & Zetzsche (2005), pp. 1044-1045.
168 Günther & Roth (2006), p. 18; Hopt (2004), p. 408.
169 Günther & Roth (2006), pp.17-18.
170 Günther & Roth (2006), p. 18. For illustrations of the abusive use of the right, also see Hasselbach & Spengler (2005), p. 114.
171 Section 131(3)(7) of the AktG (the UMAG).
172 Section 243(4)(1) of the AktG (the UMAG); also see Noack & Zetzsche (2005), p. 1044.
173 Section 243(4)(2) of the AktG (the UMAG); also see Noack & Zetzsche (2005), p. 1044.
174 Sections 246, 246a of the AktG (the UMAG); also see Noack & Zetzsche (2005), p. 1045.
175 Section 246a of the AktG (the UMAG); also see Noack & Zetzsche (2005), p. 1045.

4.3.2 *Claims arising from the director's breach of fiduciary duties*

As mentioned, a director's breach of duties generally gives rise to corporate claims, either for injunction or for damages. However, an individual shareholder may under German law bring a direct action if his own personal right, including his membership right, such as the right to participate in the shareholders' meeting or the right to dividend decided on, has been infringed by the directors' decision.[176] However, because the directors' decision was made in the name of the company, which should take legal responsibility for the decision, and also because the directors do not owe direct duties to the shareholder, such an action must be brought against the company rather than against the directors who made the decision.

Directors may owe duties directly to an individual shareholder according to contract law or law of torts. If directors breach such duties, they could be held liable for damages, and the individual shareholder can bring a direct action against them. For example, German case law has established that if directors sell shares to the purchaser in the knowledge that the shares price will subsequently fall, they will be held liable to the purchaser for the loss of the value of those shares.[177] In this case, the director's liability is based on contract law or tort law rather than the company law principle of duty of loyalty. Therefore no further attention will be paid to this type of liability.

4.3.3 *Claims arising from the shareholder's misconduct (breach of the duty of loyalty)*

It is more problematic to identify the nature of the action to be taken where the claim arises from a shareholder's misconduct. Basically, the general principle still applies that, where the injury was done to the company, only the company can claim damages against the injury; an individual shareholder can only claim damages for his direct losses which are separate from the corporate losses.[178] However, the problem is, by committing the misconduct which injured the company, the wrongdoing shareholder may also have breached his duty to other shareholders at the same time and therefore the misconduct may give rise to a shareholder's personal claim as well as a corporate claim, especially in a GmbH. The reason is that, as mentioned in Section 4.2.3, shareholders in both AGs and GmbHs owe a duty of loyalty to the company as well as to other shareholders, although the content and the scope of the duty may be different in various situations.[179] These two kinds of duties may overlap, especially in GmbHs. For

176 Kleindiek (1993), at p. 144.
177 Eckert (1960), p. 67; as cited in Singhof & Seiler (1998), p. 554.
178 Kleindiek (1993), at p. 144.
179 See Section 4.2.3. For a more detailed discussion of the shareholders' fiduciary duty, see, for example, Brinkman (2002), pp. 70-77; Scogin (1993); Miller (1997).

example, in the GmbH, misconduct such as the appropriation of the corporate assets by the majority shareholder for his own benefit may breach both his duties to the company and his duties to the minority shareholders. In such cases the distinction between direct and derivative actions may be difficult.

The German law takes a strict approach towards this distinction in cases where this very same overlap of claims exists. Under German law the identification of which action should be taken not only depends on whose right has been infringed, but also on the remedies sought. Where a shareholder has breached his duty to other shareholders by infringing the interests of the company, which is common in a GmbH, the aggrieved shareholders cannot bring a direct action against the company's losses. They can, however, seek the remedies of withdrawal or expulsion if they can establish a substantial basis for these respective remedies.[180] We should note, however, that since it is difficult for minority shareholders to bring an *actio pro socio* on behalf of the GmbH against a wrongdoing shareholder[181], and since the aggrieved shareholders who withdraw from the company can only obtain a market value for their shares[182], they may not be fully compensated in such cases.

4.4 Striking a balance between corporate efficiency and protection for the corporation and the minority shareholders

As mentioned in Section 4.1, German law concerning derivative actions in AGs has recently experienced significant changes due to the implementation of the UMAG. Therefore, in this section I will discuss the former rules as well as the current rules separately. Moreover, since minority shareholders in GmbHs cannot enforce corporate claims derivatively except against fellow shareholders by means of the right of *actio pro socio*, which is a membership right rather than a derivative right, this section will only discuss the law as it concerns AGs.

4.4.1 The rules prior to the UMAG

Before the UMAG, the minority shareholders' right to enforce corporate claims was regulated by section 147 of the AktG (1998). This section actually laid down two different mechanisms covering the minority shareholders' right as found in two separate paragraphs, subsections 1 and 3. Section 147(1) granted the shareholders' meeting, or those minority shareholders whose aggregate holding

180 Please refer to Section 4.2.3.2.1.

181 See Section 4.1.3.2.

182 There is no explicit definition of 'market value' in German law; it may not compensate the withdrawing shareholders for those indirect losses, as reflected in the GmbH's losses, which were not claimed by the GmbH.

equaled or exceeded one-tenth of the share capital, the right to request the company or special representatives of the company to enforce corporate claims for compensation of damages.[183] If the corporate claim was not enforced according to section 147(1), the minority shareholders might then apply the second mechanism, which was stipulated in section 147(3). That is, those minority shareholders whose aggregate holdings exceeded one-twentieth of the share capital or the *pro rata* amount of EUR 500,000, were allowed to apply for the court to appoint special representatives in order to assert the corporate claim provided there were facts justifying the urgent suspicion that the company had sustained a loss through dishonesty or gross violation of the law or articles. These court-appointed representatives, however, were given the discretion to decide whether to assert the claim or not. Since the restrictions on the minority shareholders' right to enforce corporate claims could be different in the two mechanisms, I will discuss them separately where it proves necessary.

4.4.1.1 Substantive limitations to the scope of misconduct which might be enforced by minority shareholders

4.4.1.1.1 Whose misconduct might be the corporate cause of action enforceable by minority shareholders

Section 147 of the AktG (1998) was mainly intended to enforce corporate claims regarding compensation for damages 'against persons liable pursuant to sections 46 to 48 and 53 which have arisen in connection with the formation of the company or which have arisen in connection with the management of the company against members of the management board or the supervisory board or pursuant to s. 117'.[184] According to section 117(1) of the AktG, any person who has exerted influence on the company and willfully induced the corporate management to act to the disadvantage of the company should be liable to the company. However, this section was not applicable if the act was engaged in through the exercise of 'voting rights at the shareholders' meeting';[185] nor is it applicable if through the exercise of 'the right to direct under a control agreement' or 'the right to direct of an acquiring company into which the company has been integrated'.[186] As a result, the liability under section 117 has not applied to the controlling shareholders. Consequently, section 147 did not apply to the controlling shareholders either. In fact, section 147 was mainly applied against members of the management board or the supervisory board. As

183 For the appointment of the special representatives, see section 147(2) of the AktG (1998).

184 Section 147(1) of the AktG (1998).

185 Section 117(7)(1) of the AktG(1998). However, section 117(7)(1) has been abolished by the UMAG. See UMAG article 1 sub-article 3.

186 Sections 117(7)(2) and 117(7)(3) of the AktG(1998), which are sections 117(7)(1) and 117(7)(2) of the AktG (the UMAG).

a result, under the former German law, with the exception of groups of companies, only the management board, which is the body designated to decide upon and to initiate a corporate action, might pursue a corporate action against the controlling shareholders.[187] However, as will be seen in Section 4.4.2.2.1, this approach has since been changed by the UMAG.

The German approach before the UMAG did in fact favor the directors' decision-making power: making a litigation decision is also a kind of business judgment. This approach could lead to a situation where the interests of the company and minority shareholders might be infringed without remedies. For example, if the controlling shareholder breached his duty of loyalty and misappropriated the company's assets through unfair dealing, the managing board should prevent such an unfair dealing or bring an action against it after the wrongdoing has taken place. However, the managing board might be controlled by this controlling shareholder and so the board would in such a case never bring the action. The complaining minority shareholders could only challenge the board's decision not to sue on the basis of breach of directors' duty of care. It would be far easier for minority shareholders if they could directly initiate a corporate action against the wrongdoing shareholder for his breach of duty of loyalty, since normally it is easier to sue against breach of duty of loyalty than against breach of duty of care.

In conclusion, section 147 was mainly aimed at disciplining the conduct of directors. This approach, if taken alone, might lead to less protection for the interests of the company and minority shareholders in those cases where the majority shareholders are abusing their power. It should be borne in mind, however, that, as mentioned in Section 4.2.3.1.2, German law still contains a variety of alternative mechanisms to solve the problem.

4.4.1.1.2 Nature of the defendant's misconduct that might lead to a corporate action enforceable by minority shareholders

Section 147(1)

Section 147(1) did not place any restriction on the nature of the director's misbehavior which could give rise to corporate claims: it applied to all kinds of breaches of duty by directors, no matter whether they were negligence or a breach of the duty of loyalty.

On the other hand, however, German case law has also acknowledged that directors should have discretion in making business judgments and should not be liable for normal business risks. A German version of the business judgment rule has been developed in German case law. In the *ARAG/Garmenbeck* case in

187 For the law on groups of companies, see Section 4.1.3.3.

1997[188], the German Federal Supreme Court (Bundesgerichtshof) for the first time held that directors should be given discretion to exercise business judgment. It stated that:

> ... directors possess a wide margin of appreciation for their activities as directors as any business activity is inconceivable without such discretion. It is within this margin of appreciation that they consciously take risks in the pursuit of business opportunities. Thus, even the most responsible director is faced with the risk of miscalculation and misjudgement. ... In this regard, there can be no liability for damages. Such liability is conceivable only where the line of responsible directorship based on the careful analysis and evaluation of the underlying facts in the light of the welfare of the company has been clearly overstepped and where the willingness to accept entrepreneurial risks has become irresponsible ...[189]

However, this German version of the business judgment rule may not provide directors with the same degree of protection as the American rule does. First, under German law, the accused director has to prove that he has employed the care of a diligent and conscientious manager[190], while under American law, it is the plaintiff shareholder who bears the burden of proof that the business judgment rule is not applicable. Moreover, it is easier for German courts than it is for their American counterparts to second-guess the directors' decisions.[191] According to German law, in order to decide whether the directors should be liable, the courts need to judge the behavior of the directors according to the standard of care of a diligent and conscientious manager, while still recognizing that directors should enjoy discretion in making business judgments.[192] The directors' discretion in making business judgments is only one factor that the courts will take into consideration when deciding such cases.[193] Thus a hindsight evaluation of the directors' behavior by the courts is unavoidable. Even worse, this hindsight evaluation is often influenced by the judges' own subjective attitude toward risk.

188 BGHZ 135, 244. For a brief introduction to this case in English, see Hirt, (2004), p. 263. Hirt (2003c), pp. 533-535.

189 BGHZ 135, 244; as cited in and translated by Bröhmer (2000), p. 55.

190 Section 93 of the AktG. German law differentiates between 'the breach of duty' (the objective aspect of the director's behavior) and 'negligence' (the subjective aspect of the director's behavior). The issue of breach of duty concerns what a director has to do or should have done; while the issue of negligence concerns how a director should act, that is, the level of care. As soon as the plaintiff can show that the defendant director has breached his duty (the objective aspect) and that the company has suffered damages as a result, then the burden of proof is reversed and the director must prove that he did comply with his duty (the subjective aspect). Nevertheless, as to the subjective aspect, German law takes an objective standard, the standard of a prudent businessman. See Stengel (1998), at p. 52.

191 Bröhmer (2000), p. 56; Butler (2000), pp. 591-592.

192 Bröhmer (2000), p. 56.

193 Hopt (1997), p. 265.

In contrast, the American business judgment rule is a safe-harbor rule, by which the American courts try to avoid second-guessing the directors' behavior. Second, the German business judgment rule may have the disadvantage of uncertainty because there are few cases concerning directors' liabilities and there have been few opportunities for German courts to develop the rule.[194] Due to these differences, especially the difference concerning the burden of proof, it has been argued that there actually is no business judgment rule under German law.[195] This opinion of course ignores the fact that German case law has adopted the substantive aspect of the American business judgment rule, that is, that the directors' discretion concerning his business judgment should be protected.[196] Therefore, we also would tend to agree that German case law has, for all intents and purposes, adopted a business judgment rule.

As will be seen, the German legislature has also recognized the importance of the business judgment rule and has introduced it into the UMAG.[197]

Section 147(3)

Perhaps due to its lower capital threshold requirement for minority shareholders as compared to that found in section 147(1), section 147(3) took a different approach to that of section 147(1) with regard to the scope of liability and, in doing so, provided more protection for directors. Contrary to section 147(1), section 147(3) awarded minority shareholders the right to force a corporate action only in limited situations of directors' breach of duty, that is, in those situations where the corporate damage arose from directors' dishonesty or gross violation of the law or of the articles of association.[198] Therefore, certain kinds of directors' breach of duties, such as mere breach of duty of care, might not be enforced under section 147(3). Although it might be more lenient on directors, this restriction did actually, to a certain extent, play a similar role to that of the American business judgment rule in protecting directors, since the aggrieved minority shareholders were not able to apply section 147(3) against the directors for their mere breaches of duty of care and the plaintiff shareholders had to bear the burden of proof that the misconduct had amounted to dishonesty or gross violation of the law or of the articles of association. However, since this restriction only applied to section 147(3), it did not affect the shareholders' right under section 147(1).

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194 Singhof & Seiler (1998), p. 572.

195 For this opinion, refer to, for example, Cunningham (1999), p. 1157. Although Jürgen Bröhmer agrees that the German Federal Supreme Court, in the *ARAG/Garmenbeck* case (BGHZ 135, 244), has adopted the principle that directors should have business discretion and should not be held liable for mere business risk, he does not say that the business judgment rule has been introduced into German law; see Bröhmer (2000), pp. 55-56.

196 See, for example, Hirt (2004b), p. 265, note 35; Oquendo (2001), p. 1011, Footnote 119; and Timmerman (2004), p. 50.

197 See Section 4.4.2.2.1.

198 Section 147(3) of the AktG (1998).

4.4.1.2 Major requirements placed on plaintiffs in order to enforce corporate claims: the procedural aspect

4.4.1.2.1 Section 147(1)

Pursuant to section 147(1), the shareholders' meeting by a simple majority or 'a minority whose aggregate holdings equal or exceed one-tenth of the share capital' could request that the company bring an action. The minority shareholders who have made such a request must have held the shares for no less than three months prior to the date of the shareholders' meeting. According to this section, it does seem necessary to hold a shareholders' meeting in order for the minority group to request an enforcement of corporate claims.[199] Although minority shareholders have been awarded the right to call a shareholders' meeting[200], this requirement might simply result in bringing more costs down on the dissatisfied minority shareholders.

The minority shareholders' right under section 147(1) did not embody a derivative action in the common law sense. The minority shareholders were not able to file an action on behalf of the company in their own names. However, they were able to ask the court to appoint special representatives to assert their claim for the company, thus substituting for the normal corporate bodies, that is, the management board or the supervisory board, which the minority shareholders might not trust.[201] An advantage to this arrangement, whereby the action might be pursued in the name of the company, was that the complaining minority shareholders were not able to control the action. Thus the issue that the complaining minorities might be able to abuse the litigation right, for example, by causing an unjust settlement between the complaining minority shareholders and the defendant, could not have arisen in Germany.

4.4.1.2.2 Section 147(3)

As seen above, the capital threshold under section 147(3) was significantly lower and more flexible than that under section 147(1). Shareholders whose aggregate holdings exceed one-twentieth of the share capital or the *pro rata* amount of EUR 500,000 might cause corporate claims to be enforced.

However, this section also laid down several significant requirements concerning the shareholders' right. First, in order for the minority shareholders to bring their motion before the court, they must show the existence of facts which justify the urgent suspicion that there has been dishonesty or gross violation of

199 See Boyle (2002), p. 47.

200 Section 122 of the AktG states that '[a] shareholders' meeting shall be called if shareholders whose holding in the aggregate equals or exceeds one-twentieth of the share capital demand such meeting in writing, stating the purpose and the reasons of such meeting…'.

201 Section 147(2) of the AktG (1998).

the law or the articles. This made a preliminary court procedure necessary for section 147(3).[202] Second, the minority shareholders' motion only had the effect of causing the court to appoint a special representative, rather than of forcing a corporate action. Only the court-appointed special representative had the discretion to decide whether to initiate the action. Moreover, minority shareholders had no influence on the court's appointment of special representatives. They might make some suggestions, but the court was not obliged to follow these suggestions.[203] These requirements, then, along with the substantive restriction mentioned in Section 4.4.1.1, might well considerably increase the difficulty for minority shareholders in enforcing corporate claims and would, as a result, diminish the significance of a lowered capital threshold.

4.4.1.3 The independent body's view

The issue of the independent body's point of view may not arise under German law since the structural arrangement of corporate litigation under German law already considers the risk of conflict of interest. For example, the power to sue all wrongdoers except the management board or its members is in the hands of the management board, while the power to sue the members of the management board is awarded to the supervisory board. A shareholder cannot vote 'on his own behalf or on behalf of any other person in respect of a resolution concerning ratification of his acts, his discharge from a liability, or enforcement by the company of a claim against him'.[204] Thus, no further discussion of the issue of the independent body's point of view is necessary.

4.4.1.4 Incentives for plaintiffs to enforce corporate claims

Compared to Anglo-American law, the previous German law did provide a negative rather than a positive incentive for minority shareholders to enforce a corporate claim.

4.4.1.4.1 The negative incentive: allocation of litigation costs

The general rules regulating litigation costs under German law are stipulated in the German Civil Procedure Code (Zivilprozessordnung, ZPO). Like many other civil law countries, section 91 of the ZPO establishes the general principle that 'the costs follow the event,' that is, the losing party bears the litigation costs of both parties involved.[205]

202 Hirt (2004b), p. 296.
203 Hirt (2004b), p. 294, Footnote 148.
204 Section 136(1) of the AktG.
205 Singhof & Seiler (1998), p. 557; Hirt (2004b), p. 302, p. 315.

A *prima facie* conclusion drawn from the above principle might be that in a suit brought under section 147 of the AktG (1998), the company, if it lost the case, should pay the litigation costs because the suit was brought in the name of the company rather than in the name of the minority shareholders who initiated such a suit. However, section 147(4) of the AktG (1998) shifted the burden of costs from the company to the minority shareholders. It provided that:

> If a minority has requested that a claim for damages be asserted and the company shall be required to bear the costs of the litigation because it has been unsuccessful in the litigation in whole or in part, the minority shall be obligated to reimburse such costs to the company insofar as they exceed what was gained from the action. If the company has been completely unsuccessful, the minority shall also reimburse to the company the court costs incurred by the company in connection with the appointment of special representatives pursuant to subsection (2) sentence 3 or subsection (3) sentence 1 and the cash expenses and remuneration of such special representatives.[206]

This provision was intended to prevent abuse of the minority shareholders' right under section 147.[207] However, it had played a role of overdeterrence. It had generally been agreed that the fact that minority shareholders had to bear the litigation costs had significantly contributed to a lack of section 147 suits in practice.[208] On the one hand, if the company won, the minority shareholders could only indirectly benefit from the suit *pro rata* based on the shares they hold. On the other hand, they had to pay the litigation costs if the company lost the case on whatever basis. The minority shareholders might not be at fault at all in initiating such a suit: we should bear in mind that, under German law, the corporate body or the court-appointed special representatives, rather than the minority shareolders, controlled the process of the action. This was even more unfair to minority shareholders in a section 147(3) case because in this case it was the court-appointed special representative who finally decided to bring the action.[209]

4.4.1.4.2 No positive incentive mechanisms: no contingency fee device

A contingency fee arrangement, which is regarded as unethical and against public policy, is still not allowed in Germany.[210]

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206 Section 147(4) of the AktG (1998).
207 The reason was stated in draft Aktiengesetz (1962), see Hirt (2004b), p. 315.
208 See, for example, Singhof & Seiler (1998), pp. 557-558; Hirt (2004b), p. 302.
209 Hirt (2004b), p. 302, Footnote 175.
210 See, for example, Singhof & Seiler (1998), p. 557; Butler (2000), p. 601.

4.4.2 Changes in the UMAG

4.4.2.1 Reasons for the reform

Section 147 of the AktG (1998) was introduced in 1998 by the KonTraG, the Law on the Control and Transparency in Business (Gesetz zur Kontrolle und Transparenz im Unternehmensbereich). However, this section has basically been regarded as a failure for several reasons.[211] First, it seems that the low threshold under section 147(3) of the AktG (1998) has made it easier for minority shareholders to force a corporate claim, especially due to the EUR 500,000 requirement for minority shareholders in big companies. However, other requirements set by section 147(3), as mentioned in Section 4.4.1, have in fact significantly limited this minority shareholders' right. Second, the former regulation concerning the shareholders' right to force corporate suits, which was found in section 147(1) of the AktG (1998), has still been maintained and the problems it has caused remain unresolved. The coexistence of section 147(1) and (3), which provides two different mechanisms for minority shareholders, might have also caused further complexity and inconsistency.[212] Third, the thresholds set by section 147, although lower than the former threshold, may still be too high for minority shareholders to enforce corporate claims.

Since section 147 of the AktG (1998) did not prove to be satisfactory, suggestions for reform arose immediately upon its introduction.[213] The most influential proposals for reform were prepared by both Ulmer and Baums, they were basically similar and suggested significant changes to section 147 of the AktG (1998).[214] In September 2000, Baums made his recommendations for reform of the 63. DJT[215], which were basically followed by the Regierungskommission Corporate Governance in its report of July 2001[216] and then implemented into law by the UMAG in 2005. This reform is indeed unusual because the Regierungskommission Corporate Governance had as its principle that of not proposing any reform with regard to provisions that had already been amended by the KonTraG. The reason for this exception was that 'public' opinion concerning the minority

211 See Hirt (2004b), p. 296. The 63 Deutscher Juristentag (DJT) in September 2000 also took this view; see Hirt (2004b), p. 306.

212 Hirt (2004b), p. 306.

213 Hirt (2004b), pp. 319-320.

214 Hirt (2004b), pp. 319-321.

215 T. Baums, 'Empfiehlt sich eine Neuregelung des aktienrechtlichen Anfechtungs-und Organhaftungsrechts, insbesondere der Klagemöglichkeiten von Aktionären?' (Gutachten F zum 63. Deutschen Juristentag Leipzig 2000 (München: C. H. Beck, 2000), p. 242; as cited in Hirt (2004b), pp. 319-321. The resolutions of the 63 DJT are published in (2000) 45 AG R439-R442; as cited in Hirt (2004b), p. 319, Footnote 240.

216 Report of the Regierungskommission, note 72; as cited in Hirt (2004b), p. 322. Also see Baums (2002), Part VII.

shareholders' right to enforce corporate claims had changed since the KonTraG.[217]

4.4.2.2 Changes in the UMAG in regard to section 147 of the AktG (1998)

The shareholders' right to enforce corporate claims has been amended several times since its first introduction in 1884. However, up until the introduction of the UMAG, there were only minor amendments. These mainly focused on lowering the capital threshold for minority shareholders to be able to enforce corporate claims, and continued to maintain the approach of favoring corporate efficiency over protecting minority shareholders. For example, according to article 223 of the Allgemeines Deutsches Handelsgesetzbuch, the predecessor of section 147 of the AktG (1998), only shareholders who held at least twenty percent of the nominal share capital could initiate the assertion of corporate claims.[218] The reform in 1965 reduced the threshold to ten percent. In 1998 the reform reduced the threshold to five percent or a *pro rata* amount of EUR 500,000, but put more restrictions on the minority shareholders' right; at the same time, the ten percent threshold mechanism was kept on.

Unlike the earlier reforms, the UMAG has made significant changes, both substantively and procedurally, to the minority shareholders' right to enforce corporate claims. These changes are mainly embodied in the newly inserted section 148, which grants minority shareholders the right to bring a derivative action. In order to avoid unnecessary inconsistency, the UMAG has repealed those regulations of the minority shareholders' right to enforce corporate claims found in the old section 147 of the AktG (1998) and has inserted a new section 148 to exclusively regulate this right. As a result, the new section 147 of the AktG (the UMAG) now only regulates the right of the general meeting of shareholders to enforce corporate claims, while section 148 regulates the minority shareholders' right to bring a derivative action. We should note that, through these amendments, the UMAG not only purports to improve the minority shareholders' position in enforcing corporate claims, but also attempts to strike a fair balance between the protection of minority shareholders and maintaining corporate efficiency.[219] The latter purpose can be detected especially in the restrictions on the minority shareholders' right to derivative actions and the newly introduced business judgment rule in section 93 of the AktG (the UMAG).

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217 Report of the Regierungskommission, note 72; see Hirt (2004b), p. 322.

218 See Hirt (2004b), p. 281.

219 For a discussion of the UMAG's effort to strike a fair balance, see Seibert & Schütz (2004), at pp. 252-253.

4.4.2.2.1 Substantive limitations to the scope of misconduct that may be enforced by minority shareholders

Whose misconduct may be the causes of derivative action

An important change in the UMAG is that shareholders, either via the shareholders' meeting, or via a derivative action, may now enforce corporate claims against controlling shareholders. As mentioned in Section 4.4.1.1.1, since section 117 of the AktG (1998) has not applied to the undue influence of the controlling shareholders, minority shareholders were not able to enforce corporate claims against the controlling shareholders based on section 147 of the AktG (1998). However, the situation has since been changed by the UMAG. The UMAG removes section 117(7)(1) of the AktG (1998)[220]; therefore, a shareholder can no longer be excused from liability under section 117 if he exerts his influence by exercising voting rights at the shareholders' meeting and so causes losses to the company. This corporate claim against the controlling shareholder can now be enforced by the shareholders' meeting or qualified minority shareholders through a derivative action.[221]

The nature of misconduct which may give rise to corporate claims

The UMAG also lays substantive restrictions on the nature of the misconduct which may give rise to minority shareholders derivative actions. As will be seen in Section 4.4.2.2.2, the UMAG adopts a two-stage procedure regarding the derivative action: the minority shareholders must first pass through a preliminary trial in order for the court to allow a derivative action; only after that will a main trial be heard. The substantive restrictions on the nature of the misconduct are actually found in both stages. At stage one, in order for the court to grant a derivative action, the minority shareholders have to establish, among other things, that there is misconduct of fraud or other gross infringement of the law, or of the memorandum and articles[222]; any other misconduct may not give rise to a derivative action. This restriction actually is the same as that found in the previous section 147(3), which, as mentioned in Section 4.4.1.1.2, was similar to the American business judgment rule in the sense that it prevented minority shareholders from challenging a director's mere breach of duty of care and then went on to provide protection for directors. Of course, we can easily observe that, due to its limited scope of misconduct which may give rise to a derivative action, section 148 of the AktG (UMAG) is more favorable to directors than the American business judgment rule.

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220 Article 1 sub-article 3 of the UMAG.

221 Sections 147 and 148 of the AktG (the UMAG).

222 Section 148 (1)(3) of the AktG (the UMAG).

If a derivative action is granted in the preliminary trial, the defendant director may also be protected by a statutory business judgment rule which was introduced by the UMAG. According to this amended section 93(1), there shall be no breach of the director's duties if the director's decision was based on appropriate information and if he could reasonably believe that he was acting in the best interests of the company.[223] However, unlike the American business judgment rule, here the defendant director, rather than the plaintiff shareholder, must bear the burden of proof.[224] Although this German approach of putting the burden of proof on the defendant director seems to provide less protection for directors than the American law does, this is in fact not the case in a derivative action, due to the two-stage procedure of the derivative action and the previously mentioned strict restrictions of the scope of actionable misconduct during the first stage.

The changes in the UMAG as to those restrictions on the nature of the misconduct which can give rise to a derivative action seem to provide more protection for corporate directors. However, as will be seen in the following section, the UMAG also significantly improved the minority shareholders' right to derivative actions. Therefore, the UMAG in fact is trying to strike a fair balance between corporate efficiency and protection of the company and minority shareholders.

4.4.2.2.2 Major requirements placed on plaintiffs to enforce corporate claims: the procedural aspect

The UMAG makes fundamental changes to the procedural requirements concerning the minority shareholders' right to enforce corporate claims. These amendments in fact change the nature of the minority shareholders' right, as well as the approach to the issue of who should make corporate litigation decisions under German law.

First, section 148 of the AktG (the UMAG) reduces the capital threshold significantly. According to section 148(1), shareholders aggregately holding one percent of the capital stock or a *pro rata* amount of EUR 100,000 may bring an action to enforce corporate claims. Therefore, this right will now be accessible to more minority shareholders.

Second, in order to avoid 'unnecessary, unfounded or harassment actions'[225], the UMAG adopts a two-stage court procedure. According to the UMAG, a preliminary trial is necessary in order to decide whether the action on behalf of the company is allowed.[226] The court will only allow the action if:

223 Article 1 sub-article 1a of the UMAG.

224 Explanatory memorandum of the UMAG, p. 24.

225 Baums (2002), p. 18.

226 Section 148(1) of the AktG (the UMAG).

1. The shareholders can produce evidence that they acquired their shares before such time as they, or, in the case of a universal successor, their legal predecessor, were forced to acknowledge the alleged violations of duty or the alleged damage on the grounds of them/it entering the public domain,
2. The shareholders can produce evidence that the company has failed to resolve the claim itself within a reasonable period of time, despite having been notified of the claim by the shareholders,
3. There is evidence to justify the suspicion that the company has sustained damage, whether by fraud or by other gross infringement of the law, or of the memorandum and articles, and
4. There are no predominant (überwiegenden) grounds (i.e. the interests (Gesellschaftswohls) of the company) preventing the claim for damages.[227]

Several issues should be noted regarding those factors considered by the court when making a decision. First of all, a demand on the company is necessary in order to prevent multiplicity of actions. However, the company's decision not to sue will not bar a derivative action. Nevertheless, the court is granted discretion to decide whether to allow a derivative action, especially taking into account the last factor it will consider.

Third, those minority shareholders who succeeded in the preliminary trial are allowed to enforce the corporate claims in their own names in the main trial; no special representatives are needed to represent the company in the trial.[228] The UMAG also stipulates that the plaintiff shareholders should seek damages for the benefit of the company[229], and the judgment, whether successful or not, should be binding on the company and other shareholders.[230] Therefore, a common law sense derivative action has actually been adopted by the UMAG.

4.4.2.2.3 The plaintiff's incentives

The UMAG tries to encourage minority shareholders to enforce corporate claims by reducing the plaintiff's under-incentive problems. This can be seen from the following aspects.

The allocation of litigation costs

The rules concerning the allocation of litigation costs in the AktG (1998) had the effect of deterring minority shareholders from enforcing corporate claims. This has been recognized and therefore the UMAG has also changed the law on the allocation of litigation costs.

227 Section 148(1) of the AktG (the UMAG).
228 Section 148(1) of the AktG (the UMAG).
229 Section 148(4) of the AktG (the UMAG).
230 Section 148(5) of the AktG (the UMAG).

As mentioned in Section 4.4.1.4.1, the general rule regulating litigation costs under German law is that 'the costs follow the event'.[231] This general rule also applies to the preliminary procedure according to the UAMG. If the preliminary procedure brought by the minority shareholders is dismissed, the minority shareholders must bear the litigation costs of the preliminary procedure, unless the dismissal is based on grounds adverse to the interests of the company, something which the company should have notified the court of in advance but failed to do; in this latter case, the company must pay the plaintiff's costs.[232]

If the minority shareholders succeed in the preliminary procedure, costs will be apportioned in the main trial.[233] Actually, the allocation of litigation costs in the main trial favors the plaintiff minority shareholders. According to section 148(6) of the AktG (the UMAG), if the minority shareholders have succeeded in the preliminary procedure, but fail or partly fail in the main trial and therefore have to bear the litigation costs, they have the right to be reimbursed by the company for those costs, unless the allowance of the claim was based on assertions that were willfully or grossly and negligently wrong. The new rule is reasonable since the company, which profits from the action, should also bear the risk of the litigation costs.

The right to information

At the same time the UMAG has also reduced the capital threshold for a special audit to the same level as that of the minority shareholders' derivative actions.[234] In other words, shareholders holding at least one percent of the share capital or a *pro rata* amount of EUR 100,000 can apply for a special audit. This provides an opportunity for the minority shareholders who want to bring a derivative action but who lack the evidence to do so.

The shareholders' forum (Aktionärsforum)

The UMAG has also inserted a new section 127a, which requires that an AG provide a forum in the German electronic federal gazette (elektronischen Bundesanzeigers). This forum is expected to enhance communication among shareholders and help to form a quorum necessary for the minority shareholders' actions.[235] This will of course play a positive role in encouraging minority shareholders' derivative actions.

231 Section 91 of German Civil Procedure Code (Zivilprozessordnung, ZPO).
232 Section 148(6) of the AktG (the UMAG).
233 Section 148(6) of the AktG (the UMAG).
234 Section 142(2) of the AktG (the UMAG).
235 Günther & Roth (2006), p. 18.

4.4.2.3 Comments on the reform

The reform in the UMAG as to the minority's right to enforce corporate claims has undoubtedly been affected by the Anglo-American approach and aims to strengthen this right. This reform, however, has generated debates in Germany especially as to its effect on improving corporate governance.

One position on the reform finds it doubtful that the new rules will end up improving German corporate governance as a whole.[236] The main reason for this is that the new rules may not effectively deter strike suits: the threshold is regarded as too low and the preliminary trial may not effectively filter out strike suits.[237] Moreover, a preliminary trial itself may actually be a strike suit.[238] The influence of strike suits on corporate management is multiple: they unjustly interfere with corporate management and prevent directors from taking business risks or even from doing their jobs. Although the court does have discretion in the preliminary trial, this discretion is limited since it mainly exists where there are no predominant grounds (with regard to the company's interests) against the assertion of the claim for damages.[239] Of course, what the 'predominant reasons' are still depends on the court's decision. Another reason is that this lenient approach towards derivative actions may deter day-to-day supervision of the board due to a 'race to the courts'.[240] It has also been suggested that market disciplinary mechanisms would be more effective than derivative actions, more specifically, a liability mechanism, since directors are more vulnerable to losses in reputation than financial losses.[241]

Interestingly, there is also a contrary approach regarding this reform. Although he agrees that the reform does move in the right direction, Hirt has criticized the reform from an aspect different from that of the first opinion discussed above. The criticisms behind his stance are, first, that although the UMAG has reduced the capital threshold and solved the plaintiff shareholders' under-incentive problem by a new rule of allocation of litigation costs, minority shareholders may still have no adequate incentive for bringing a derivative action, especially as they still bear the risk of the costs of the preliminary procedure.[242] Second, the capital threshold may be unnecessary since it might not effectively filter out strike suits and might actually deter merit cases. Alternatively, the preliminary procedure and the allocation of litigation costs may well provide those mechanisms sufficient to deter strike suits.[243] Third, it is problematic that only fraud or gross violations are

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236 See, for example, Noack & Zetzsche (2005), p. 1053; Hirt (2005c), at p. 222.
237 Noack & Zetzsche (2005), p. 1053; Hirt (2005c), at p. 222.
238 Hirt (2005c), at p. 222.
239 Section 148(1) of the AktG (the UMAG). See Section 4.4.2.2.2.
240 Noack & Zetzsche (2005), p. 1053.
241 Noack & Zetzsche (2005), p. 1053, Footnote 101.
242 Hirt (2005c), at pp. 223-224.
243 Hirt (2005c), at p. 223.

allowed to give rise to derivative actions because damage to the company through other violations, if not redressed, may also not be in the interests of the company.[244] Fourth, the involvement and discretion of the courts in judging whether an action is in the interests of the company, which is itself a business judgment, is questionable.[245] Fifth, the two-stage court procedure may not be the best way to decide whether to allow a derivative action. On the one hand, the preliminary stage, where a decision as to whether to admit a derivative action must be made, may turn into a mini trial, while, on the other hand, the very nature of the preliminary stage may force the court to make a decision based only on a superficial examination.[246] In fact, Hirt concludes that whether the new derivative action will be significant in practice actually depends on the court's practice, and that it is unlikely that there will be a great number of derivative actions in the future.[247]

4.4.3 Limiting directors' financial exposure to the risks and costs of litigation

Under German law, if they are held liable to the company, it is difficult for directors to escape financial risks. This may prove to be a negative factor in encouraging corporate management.

This difficulty in escaping financial risks may be identified through the following aspects. First, directors' liability to the company arising from their breach of duty normally cannot be excluded or limited, except where they are obliged to follow the lawful instructions of the shareholders.[248]

Second, the waiver or settlement of corporate claims against directors is also difficult in AGs. In AGs, the company may waive or reach a settlement for the company's claims only on expiration of a three-year period after the claims have arisen and with the consent of the shareholders' meeting, and a minority of shareholders (ten percent of the share capital) can object to the waiver or settlement.[249] In addition, the waiver or settlement does not prevent a creditor of the company from suing the management on behalf of the company.[250] Nevertheless, in GmbHs the approach is more pro-directors. The waiver or settlement is only restricted to the consent of shareholders; there is no time limit or any minority shareholders' right of objection.[251]

Third, a company will not indemnify directors if they breach their duties to the company and are held liable for this. Nevertheless, if directors are held liable by

244 Hirt (2005c), at p. 224.
245 Hirt (2005c), at p. 224.
246 Hirt (2005c), at p. 224.
247 Hirt (2005c), at p. 224.
248 Section 93(4) of the AktG. Also see Wegen et al. (2006), Question 16; Baums (1996), at p. 322.
249 Section 93(4) of the AktG.
250 Section 93(5) of the AktG.
251 Baums (1996), at p. 323.

third parties, the company may indemnify them if their conduct will not make them liable to the company.[252]

The good news for directors is that they may ask the company to buy D&O insurance to cover their liability, including the liability to the company, with the company paying the insurance premiums.[253] However, this insurance would not cover liability arising from certain misconduct, such as willful breaches of duties, fraud, dishonesty or criminal behavior.[254] In addition, the German Corporate Governance Code also recommends that if the company does take out a D&O liability insurance policy for the boards, a suitable deductible (that is, a fixed amount or percentage the board member has to pay despite the insurance[255]) should be agreed upon.[256] This recommendation, although disputed, has been widely adopted.[257]

4.5 Conclusion

4.5.1 The function of the minority shareholders' right to enforce corporate claims in German corporate governance

Both theoretically and practically the minority shareholders' right to enforce corporate claims has played an unimportant role in Germany. German law on this issue actually reflects the German culture of favoring directors and of being afraid of shareholder's strike suits.

Although under German law the minority shareholder's right to enforce corporate claims is rather weak, we cannot take it for granted that minority protection is weak as well. In fact, it is difficult and inappropriate to compare the German law on shareholder rights and remedies with the English or the American law and then simply conclude that one of the countries provides better protection for the company and shareholders. The reason is that the major mechanisms applied in these countries to improve corporate governance are different. Unlike the English and the American law, German law traditionally has not focused on liability rules (or shareholder rights and remedies) to discipline directors and corporate management, but on a structural system of checks and balances. For more details on these mechanisms, please refer back to Section 4.2.3.

Nevertheless, these traditional German mechanisms are facing challenges, and reforms of the whole of German law are now in progress. Current German reform shows that an approach closer to the Anglo-American one, which pays more attention to shareholder rights and remedies, has been adopted in Germany.

252 Wegen et al. (2006), Question 16.
253 Wegen et al. (2006), Question 17; Baums (1996), at pp. 323-324.
254 Baums (1996), at p. 323.
255 Wegen et al. (2006), Question 17.
256 Section 3.8 of the German Corporate Governance Code (last amended on June 2, 2005).
257 Wegen et al. (2006), Question 17.

This may partly be because of the problems in current German corporate governance, and partly because of the influence of globalization on the economy. The reform of the minority shareholders' right to derivative actions in the UMAG actually reflects this approach. Moreover, there is also a body of opinion that such a right should also be included when it comes to a GmbH.[258]

However, as far as derivative actions are concerned the effect of the reform is still to be seen since the new law gives the court power and discretion to decide whether to allow a derivative action or not. Bearing in mind the German tradition, perhaps we have to admit that this minority shareholder right is unlikely to be at the forefront of German corporate governance. In fact, although there are criticisms of them, the traditional German mechanisms such as the supervisory board are still heavily relied upon and reforms to them have also been made.[259]

4.5.2 The German model of striking a balance between corporate efficiency and protection of the interests of the company and the minority shareholders

4.5.2.1 The appropriate body to make a litigation decision in the best interests of the company

The German approach towards the issue actually shows that under German law the minority shareholders' right to enforce corporate claims is considered distasteful.

The supervisory board and the shareholders' meeting

The German approach towards the issue of what is the appropriate body to make a corporate litigation decision has its own features. While the management board generally has the power to make a corporate litigation decision, the supervisory board, which is granted the power of supervision and is regarded as being independent from the management board, also has the power and the obligation to do so where the management board has a conflict of interest in making the decision. The supervisory board is actually regarded as the major mechanism for disciplining the management board and protecting the interests of the company. In addition to the supervisory board, the shareholders' meeting also has the power to make such a litigation decision. In GmbHs where there is no supervisory board, this function is assumed by the shareholders' meeting.

258 Baums (1996), at p. 322, Footnote 41.

259 For example, the German Corporate Governance Code addresses many ways to improve the function of the supervisory board, such as encouraging 'cooperation between executive and supervisory boards' (Part 3) and imposing on the supervisory board the task of regular supervision and of ensuring the independence of the supervisory board (Part 5).

The minority shareholders

Another feature of the German law concerns the minority shareholders' right to enforce corporate claims against directors. There are several characteristics to this. First, only the minority shareholders of AGs can enforce corporate claims against directors; such a right does not exist in GmbHs.

Second, before the UMAG, the minority shareholders could not initiate the action in their own names. Instead, they had to ask the corporate body or the special representative to bring the action in the name of the company. The UMAG has now changed this approach.

Third, the minority shareholders' right under German law is a group right as opposed to an individual right as is the case in Anglo-American law. Only shareholders who pass the capital threshold can enforce corporate claims. This group approach has been taken for more than one hundred years in Germany. When the predecessor of the current section 148 was adopted in 1884, the legislators rejected the individual approach, fearing that to give an individual shareholder the right to enforce corporate claims would unjustly interfere with corporate management.[260] Although the law has been amended several times since then, the group approach has continued to be followed, despite the dispute over whether an individual approach should be adopted in Germany.[261]

The group right approach, as a German feature, has attracted much debate. The argument for the group right approach is that the capital threshold, as a method of preventing strike suits, is objective and easy to enforce. Therefore, broad interference in the suit by the courts is not necessary. This may be more suitable for Germany, which is not a case-law country and traditionally does not grant very much discretion to the courts. Contrarily, there are also arguments against the capital threshold. The major reason is that 'bright-line rules always run the risk of being both under-and-over-inclusive'.[262] On the one hand, no matter what the threshold is, there may always be 'small' shareholders who cannot meet the requirement but want to bring an action against misconduct. Injuries may not be compensated if such an action cannot be allowed. On the other hand, the capital threshold only, no matter how high it is, cannot guarantee that all actions initiated by the minority group of shareholders are in the best interests of the company. The minority group of shareholders may pursue the action for their own group interests, for example, using the action as a weapon against the majority shareholders. Moreover, any minimum capital holding requirement is arbitrary.

The fourth feature of the minority shareholders' right to enforce corporate claims under German law is that this right may not be blocked by the negative litigation decision of the shareholders' meeting or the supervisory board.

260 See Hirt (2004b), pp. 280-281.

261 Hirt (2004b), p. 281; also see Singhof & Seiler (1998), pp. 566-567.

262 Singhof & Seiler (1998), p. 567; Hirt (2004b), pp. 308-309.

Although the UMAG requires that the qualified minority shareholders should first make a demand on the company before they initiate the preliminary procedure, the refusal of the company to sue will not be able to prevent them from initiating the preliminary procedure.

Lastly, the minority shareholders alone, especially a small group of minority shareholders alone, may not be considered an appropriate body to make a corporate litigation decision. Therefore, an outside trustee such as the special representative or the court may be granted the power to make this litigation decision. I will discuss this in the following section.

An outside trustee such as the special representative or the court

Fearing that a small group of minority shareholders may abuse their right to enforce corporate claims, the former section 147(3) of the AktG (1998) and the current section 148 of the AktG (the UMAG) has taken the approach of adopting both the decision-right strategy and the trusteeship strategy. In other words, qualified minority shareholders only have the right to trigger an action for the company, while an outside trustee, such as the special representative under the former section 147(3) of the AktG (1998) or the court under the current section 148 of the AktG (the UMAG), will be the one who makes the final decision as to whether to bring or allow such an action.

4.5.2.2 The trend towards the Anglo-American model of striking a balance between corporate efficiency and protection of the interests of the company and the minority shareholders

As mentioned, traditionally the minority shareholders' right to enforce corporate claims has been restricted under German law. Before the KonTraG in 1998, minority shareholders in German AGs faced high capital thresholds for enforcing corporate claims against directors. As a result, there were few other restrictions placed on this minority's right and there were no mechanisms created for protecting directors since any opportunity for the minority to abuse this right was extremely rare. On the one hand, section 147(3) of the AktG (1998) which was inserted by the KonTraG has lowered the threshold, but, on the other hand, has placed more restrictions on the minority's right to initiate the assertion of corporate claims. The most important feature of these restrictions was that of granting the special representatives the power to decide whether to assert that claim. However, this section has not proved successful in practice.

Partly due to the failure of the former section 147 and partly due to the influence of Anglo-American law, where more attention is paid to the liability rules, the UMAG, it seems, has turned to the Anglo-American approach in order to make the rules for the minority's right to enforce corporate claims. This can be illustrated by the following changes. First, the minority's right to enforce corporate claims has been facilitated. Derivative actions in the common law sense are now

allowed. This at least procedurally facilitates the minority shareholders' right to enforce corporate claims. More significantly, the lower capital threshold makes the right available to more minority shareholders. Although the individual approach is still rejected, the new threshold represents considerable progress under German law. Second, the minority shareholders may also bring a derivative action against the controlling shareholders. Third, as a consequence of the strengthened right of the minority, the UMAG has also provided more protection for corporate management in order to strike a fair balance. There are more restrictions, both substantively and procedurally, on the minority's right to bring a derivative action. Moreover, a statutory business judgment rule has been introduced to provide more protection for directors. Fourth, the court has been awarded more power and discretion through the two-stage procedure. Of course, whether the Anglo-American approach will be successful in Germany still remains to be seen.

Chapter 5
China

5.1 Introduction to Chinese law on derivative actions

5.1.1 Background

5.1.1.1 The history of Chinese company law

Historically the Chinese corporate system and company law are the result of transplantation. The business organization of the company did not develop naturally in China but was transplanted from Western countries. In the late 19th century (Qing Dynasty), China fell behind Western countries economically and suffered from invasions by Western countries. It was at that time that the concept of the company was introduced into China because the corporate system was regarded as one reason for the economic development found in Western countries. The earliest Chinese companies were established in order to achieve economic progress. In the beginning of the 20th century, the Qing Dynasty, under pressure from Western countries, began drafting commercial laws including company law in order to regulate companies and facilitate economic development. These laws were mainly inspired by the laws of Western countries, especially German and Japanese law. In 1904 (Qing Dynasty) the first Chinese Company Law (Gongsilü) was enacted and came into force. It was one of the earliest commercial acts in Chinese history. Companies and company law continued to be developed in China up until 1949.

However, the development of the corporate system turned out not to be as successful as had been expected. Many reasons, such as social instability, foreign monopolies, bureau monopolies and corruption, might well account for this unsatisfactory development. But, in addition, it was undeniable that the gap between the Western corporate system and traditional Chinese culture also contributed to this lack of success.[1] For example, the Western corporate system requires the operation of the company to be subject to laws and rules, corporate law must balance the interests of the various participants, and democracy and publicity is needed so as to achieve this balance. However, at that time in China

1 For a detailed discussion of this gap, please refer to Li X. (1997).

the ideas of one-man rule and the patriarchal clan system were deeply rooted, while both democracy and publicity were unfamiliar. As far as company law was concerned, this gap led to poor protection for minority shareholders. Actually, there were few regulations in company law which provided any protection for minority shareholders and even those regulations that did exist were hardly ever complied with. For example, the shareholders' meeting hardly played any role, since the company was generally regarded as belonging to the controlling shareholder and corporate management was generally controlled by this controlling shareholder.

During the period between 1949 and 1978, all companies were gradually replaced by state-owned enterprises due to the adoption of a planned economic system by the Communist government. As a result, companies and company law in the sense of Western countries ceased to develop. It was not until the end of the 1970s that the situation began to change. Beginning in 1978 China commenced economic reforms, aimed at transforming the planned economy into one in which market forces played an increasingly important role. The reforms began with the opening of China to foreign trade and investment. Later they were further developed step by step to cover various other aspects. One important aspect of these economic reforms has been the reform of state-owned enterprises (referred to as 'SOE'), which were notorious both for inefficient management and for the *de facto* absence of any owner's control. Several reform strategies had been tried one after another, such as increasing the enterprise's autonomy, clarifying the enterprise's financial goals through contracts between the enterprise and the relative government departments, leasing the enterprise, and increasing the responsibility of factory directors. Despite this, each of the strategies had their own deficiencies and none of them proved satisfactory. In the end reform focused on corporatization of the SOEs, or in other words, reorganizing and reforming the SOEs according to the corporate system.[2] At the same time, privately owned companies and foreign-investment enterprises and companies were also being developed.

The Chinese legal system was being constructed at the same time as these economic reforms were taking place. Laws and regulations governing enterprises were being published and implemented. Since the economic reforms began by allowing foreign investment in China, the first enterprise law was 'the Law of the People's Republic of China on Sino-foreign Joint Equity Ventures' in 1979. This was followed by two other foreign investment enterprise laws: 'the Law of the People's Republic of China Concerning Enterprises With Sole Foreign Investment' in 1986 and 'the Law of the People's Republic of China on Sino-foreign Cooperative Joint Ventures' in 1988. Nevertheless, there was no statutory law concerning companies in general until 1994. Before the enforcement of Company

2 A result of the reform was that the 1994 company law served the interests of reform.

Law 1994, domestic companies were regulated by scattered ordinances, local regulations, and governmental rules.[3]

On December 29, 1993, the Company Law of the People's Republic of China was promulgated, which was effective as of July 1, 1994. Like the German company law, the Chinese Company Law also classified two types of companies: limited liability companies [You Xian Ze Ren Gong Si] (including the wholly state-owned companies), which are equivalent to Western private companies or close companies, and companies limited by shares (or stock companies) [Gu Fen You Xian Gong Si], which are equivalent to Western public companies. These two types of companies were regulated separately in certain aspects, such as formation of a company and the organizational structure, but uniformly in other aspects such as general principles, corporate bonds, financial affairs and accounting, merger and division, and dissolution and liquidation. Companies subjected to the regulation of the Company Law had to be constituted as 'limited liability companies' or 'companies limited by shares.' Otherwise, other laws would be applicable, even if the name of the business organization included the term 'company.' This technique of legislation has been followed by Company Law 2006.

One important feature of Company Law 1994 was that it was purported to serve in the reform of the SOEs. Therefore, many articles including the regulations on corporate governance in the Company Law reflected this purpose.[4] For example, according to the Company Law the shareholders' meeting was superior to other intra-corporate bodies and the board of directors and the supervisory board had to be responsible to the shareholders' meeting.[5] However, although the intent of this law did play an important role in reforming the SOEs and did

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3 Such as the regulations on privately owned limited liability companies in 'Zhonghuarenmingongheguo Siying Qiye Zanxing Tiaoli [the PRC's Provisional Regulations on Privately Owned Enterprises],' which was promulgated on June 25, 1988; 'Shenzhen Shi Gufenyouxiangongsi Zanxing Guiding [the Provisional Regulations on Stock Companies of Shenzhen],' which was established on May 18, 1992. The most important governmental rules included 'Gufenyouxiangongsi Guifan Yijian [Opinion on Standards for Companies Limited by Shares]' and 'Youxianzerengongsi Guifan Yijian [Opinion on Standards for Limited Liability Companies],' which were published by the State's Commission on the Restructuring of the Economic System ('CRES') on May 15, 1992.

4 Other articles include, for example, article 4 of Company Law 1994, which stipulated that 'Ownership of the State-owned assets in a company belongs to the state.' Article 5: 'Under the state's macro regulation and control adjustment, a company organizes its production and operations autonomously according to market demand with the objective of raising economic efficiency and labor productivity and preserving and increasing the value of assets.' Article 7: 'A state owned enterprise which is being reorganized as a company shall replace its system of operation, gradually and systematically take inventory of its assets and verify its capital, determine property rights, clear creditors' rights and indebtedness, value assets and set up a standardized internal management structure in accordance with the law and conditions and requirements of administrative regulations.' Chapter 2, Subchapter 3 (articles 64 to 72) of Company Law 1994 regulated the wholly state-owned companies.

5 See, for example, articles 37, 38, 46, 102, 103 and 112 of Company Law 1994.

accelerate economic development, it also led to a serious deficiency in Company Law 1994: Company Law 1994 barely restricted the power of the majority shareholders and provided little protection for minority shareholders.

Due to the progress of Chinese economic reform and the development of the corporate system, the 1994 Company Law became outdated. It was criticized for many problems, such as the high thresholds for establishing new companies and unfavorable restrictions hindering investment, as well as a lack of mechanisms for preventing abuse of power by majority shareholders and directors and for providing protection for the company and minority shareholders. Therefore, a reform of Company Law 1994 was proposed shortly after its implementation. Although the Company Law was amended twice, in December 1999 and in August 2004 respectively, these amendments were very minor and had no significant influence on major corporate issues, including corporate governance.[6] On October 27, 2005, the broadly amended Company Law was publicized and then came into force as of January 1, 2006. The amendments in this new company law cover several aspects. For example, they reduce the thresholds for setting up a new company, allow for the one-person company, and give the company more autonomy. The law also improves the structure of corporate governance and provides more protection for the company as well as for minority shareholders.

5.1.1.2 *Characteristics of the regulations on corporate governance in Chinese company law*

The regulations on corporate governance in Chinese company law have certain characteristics which reflect the civil law tradition of Chinese company law and its special purpose.

Firstly, in both limited liability companies and stock companies the shareholders' general meeting is superior to other corporate bodies. At least three aspects in Company Law 1994 have reflected this shareholder supremacy: (1) the shareholders' general meeting was regarded as the company's authoritative organization.[7] (2) The shareholders' general meeting had wide power over corporate management.[8] (3) The board of directors was responsible to the shareholders'

6 Therefore, I will not discuss these two amendments here.

7 Articles 37 and 102 of Company Law 1994.

8 Article 38 of Company Law 1994 stipulated that the shareholders' meeting of limited liability companies had the power: '(1) to decide on the company's operational policies and investment plans;
(2) to elect and replace directors and decide on matters relating to the remuneration of directors;
(3) to elect and replace the supervisors who are representatives of the shareholders, and decide on matters relating to the remuneration of supervisors;
(4) to examine and approve reports of the board of directors;
(5) to examine and approve reports of the board of supervisors or any supervisor(s); →

meeting.[9] Therefore, the shareholder's position as a whole has been strengthened in the sense that the general meeting has more power to deal with corporate management. The reason behind shareholder supremacy in Company Law 1994 was, at least partly, that Company Law 1994 was intended to serve as a reform tool for state-owned enterprises. In order to maintain the state's control of the enterprises, the shareholders had to be given adequate power to control corporate management. This, however, could have had the side effect that the controlling shareholder would have been able to abuse his power if there was no restriction on such power. As will be seen later, this abusive use of power by controlling shareholders actually has been a serious problem in Chinese corporate governance.

The amended Company Law 2006 still adheres to the trend of shareholder supremacy. The above-mentioned articles in Company Law 1994 have been retained in Company Law 2006.[10] Nevertheless, a significant improvement in Company Law 2006 is that it contains several regulations which restrict the power of the controlling shareholders and protect the interests of the companies and minority shareholders.[11]

Secondly, as in Germany, Chinese company law has adopted a two-tier system. That is, a supervisory board, or one or two supervisors in small limited liability companies, is required in order to supervise the board of directors. It stipulates that the supervisory board shall be composed of representatives of the shareholders and members elected by the staff and workers of the company and that the supervisors elected by the staff and workers shall not be less than one-third of the board.[12] However, in practice the function the supervisory board or the supervisors has played has not been satisfactory.[13] Therefore, in order to strengthen control over the board of directors in listed companies, the Chinese

(6) to examine and approve the company's proposed annual financial budget and final accounts;
(7) to examine and approve the company's plans for profit distribution and recovery of losses;
(8) to decide on increases in or reductions of the company's registered capital;
(9) to decide on the issue of bonds by the company;
(10) to decide on transfers of capital contribution by shareholders to a person other than a shareholder;
(11) to decide on issues such as merger, division, change in corporate form or dissolution and liquidation of the company;
(12) to amend the company's articles of association.'
The shareholders' general meeting of stock companies had similar power; see article 103 of Company Law 1994.

9 Articles 46 and 112 of Company Law 1994.

10 See articles 37, 38, 47, 99, 100, and 109 of Company Law 2006, contrasting articles 37, 38, 46, 102, 103, and 112 of Company Law 1994, respectively.

11 For a more detailed discussion, please refer to Section 5.1.1.4.3.1.

12 Articles 52 and 118 of Company Law 2006.

13 For the reasons, see Section 5.1.1.4.3.1.

Securities Regulation Commission (the CSRC) has introduced the mechanism of independent directors. The CSRC's 'Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies 2001' requires that listed companies fill one third of their boards with independent directors.[14] As a result, currently in Chinese listed companies there exist both independent directors as well as a supervisory board.

Thirdly, the 'legal representative' of a company plays an important role in corporate governance. 'The legal representative' is a special concept in Chinese law. According to article 38 of the 'General Principles of the Civil Law of the People's Republic of China,' the legal representative of a legal person is 'the responsible person who acts on behalf of the legal person in exercising its functions and powers' in accordance with the law or the articles of association of the legal person. Company Law 1994 stipulated that the legal representative of a company should be the chairperson of the board of directors or the executive director in small limited liability companies where there was no board of directors.[15]

Although the legal representative is not a corporate body and the power to make a corporate decision still lies with the board of directors rather than with the legal representative, he does play an important role in corporate business since he represents the company vis-à-vis a third party by exercising the board's decision under both substantive and procedural law. For example, article 49 of Chinese Civil Procedure Law requires that 'a legal person shall be represented by its legal representative in the proceedings.'

However, it may become problematic if only the legal representative is able to act on behalf of the company vis-à-vis third parties. Most importantly, when the legal representative is unable or unwilling to represent the company, or his representation would lead to a conflict of interest between himself and the company, who should replace him and represent the company? Under Company Law 1994, the only way to do this was to change the chairperson of the board, since he was the legal representative according to the law. Nevertheless, this change was time-consuming and costly. It was not suitable in an everyday business context. Recognizing the problem of the legal representative in Company Law 1994, Company Law 2006 broadens the scope of candidates for legal representative and gives the company more freedom to choose legal representatives. Article 13 of Company Law 2006 stipulates that according to the articles of association, the chairperson of the board of directors, executive directors or the manager can be the legal representative(s) of a company; it is uncertain whether there can be more than one legal representative in a company or not. However, the amendment to Company Law 2006 may not totally solve the problem of the legal representative. Since only one or a few directors or managers

14 Article 1(3) of the Guidelines.
15 Articles 45, 68 and 113 of Company Law 1994.

may be the legal representative(s), and since the articles of association must be amended in order to change the legal representative(s) and the change must be registered, the problem that the company might end up not being justly represented still exists under the new law. The solution may well be that the representative should not be settled on *ex ante* and that the company should have the freedom to choose its representative in any given case.

The fourth characteristic of corporate governance in China is that minority shareholders are in a weak position. I will discuss this feature in detail in Section 5.1.1.4.2.

5.1.1.3 The major agency problems in Chinese companies

As we know, the derivative action is a mechanism that provides protection for the company and minority shareholders against the misconduct of corporate controllers, that is, the majority shareholders and/or the directors. We also note that due to its defects, the derivative action is here more effective against the directors than against the controlling shareholders.[16] Therefore, it is important to identify the major agency problems in Chinese companies in order to observe the position of minority shareholders and the function of derivative actions.

The agency problems in limited liability companies

As in Western countries, in Chinese limited liability companies there are only a few shareholders (no more than fifty shareholders[17]) and normally these shareholders take part in corporate management. Therefore, the major agency problem in Chinese limited liability companies is also the conflict between the controlling shareholders and the non-controlling shareholders. We should note, however, that due to the system of the legal representative, the controlling shareholder is not necessarily the one who owns the majority of share capital; instead, the shareholder, who controls the legal representative, may be the controlling shareholder. For example, in the cases of *Zhongtian v. Bichun, etc.*[18], Zhongtian Co., as a shareholder, held sixty percent of the capital of the joint venture named Yanzhong Co. Nevertheless, Yanzhong Co. was controlled by the second largest shareholder, Yanzhongshiye, which owned thirty per cent of the capital of Yanzhong since the legal representative of Yanzhong was on its side.

Where the controlling shareholder is the state, there may also be conflict between the shareholders and the directors of the company. In China, local offices of the Bureau of State Property Management (the BSPM) exercise the shareholder's

16 Section 1.3.
17 Article 20 of Company Law 1994; article 24 of Company Law 2006.
18 No. 2 Intermediate People's Courts of Shanghai, (1996) Hu Er Zhong Jing Chu (Zhi) No. 529, in Li C. (1999), pp. 321-330.

rights on behalf of the state. However, the BSPM may not perform its function well and the shareholder rights of the state may not be exercised. Therefore, the company may be in the control of the directors and/or officers of the company; in China this situation is called 'insider controls.'

The agency problems in stock companies

Both agency problems mentioned above also exist in stock companies, including listed companies. The major agency problem in Chinese stock companies is still the conflict between majority and minority shareholders. In fact, the most serious problem in Chinese stock companies is the misconduct of the controlling shareholders. It is common for the controlling shareholders to misappropriate the corporate assets by related-party transactions or in other ways. Several factors may account for the situation. The first is the highly concentrated shareholding structure in stock companies. In China, even in listed companies, the shareholding structure is normally highly concentrated. Jin Xin conducted a statistical research project. He studied 425 companies listed on the Shanghai Stock Exchanges from April 1999 to April 2003.[19] The statistics show that there were 228 companies (fifty-four percent of the sample companies) in which the largest shareholder owned more than fifty percent of the shares. The following table is based on his study[20]:

The degree of concentration of shares in the 425 sample companies

The percentage of shares owned by the largest shareholder	Number of companies	Percentage of the total sample of companies (%)
0-10%	3	0.7
10-20%	17	4.0
20-30%	49	11.5
30-40%	58	13.7
40-50%	70	16.5
50-60%	94	22.1
60-70%	77	18.1
70-100%	57	13.4

Another characteristic of the shareholding structure in listed companies is that in most of the listed companies the largest shareholder is the state or state-owned/controlled entities. This is also shown in Jin Xin's study. In 338 of the 425 sample companies (79.5%) the largest shareholder was the state or state-owned/controlled entities.[21] This high concentration of shareholding structure, as

19 Jin (2005), pp. 76-77.
20 Jin (2005), Figure 6-4, pp. 76-77.
21 Jin (2005), p. 76.

well as the special position of the state or state-owned/controlled entities, together easily leads to a situation in which the listed companies are controlled by the controlling shareholder(s).

Second, even in the listed companies where the shareholding structure is not highly concentrated, the largest shareholder, who normally holds less than twenty percent of the shares, still controls the management of the company.[22] The largest shareholder is normally an industrial enterprise rather than an investment institution; its major purpose is to control the management of the company rather than to maximize profits through dividends or by an increase in share price.

Third, as mentioned, from the beginning the corporate system was regarded as taking on the role of reform in state-owned enterprises. In China, many stock companies, especially listed companies, were originally traditional stated-owned enterprises and the state or state-owned/controlled entities normally owned the majority of the corporate shares. Preserving and increasing the value of state properties is at least one of the main purpose(s) of such companies. However, this purpose may be in conflict with the interests of the company and of minority shareholders.

Fourth, as mentioned, the patriarchal system has long been deeply rooted in Chinese culture and there has been a lack of democracy throughout this long history; it is common for the controlling shareholder to consider the company to be his own property.

Fifth, due to the special situation in Chinese stock markets, where in most listed companies only a small portion of shares are freely tradable on the stock exchanges, there is no market mechanism for disciplining the conduct of the controlling shareholders, who normally own non-tradable shares.[23]

Last but not least, before Company Law 2006 there were few regulations for disciplining the conduct of the controlling shareholders and for providing protection for the company and minority shareholders. Therefore, the controlling shareholder could abuse his rights almost without restriction or penalty.

The conflict between shareholders and directors/officers also exists in stock companies, especially in the companies where the controlling shareholder is the state. The reason is the same as that for limited liability companies.

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22 An exception is China Minsheng Banking Corp., Ltd; see Jin (2005), p. 116.

23 In China the shares of listed companies are divided into tradable shares which can be freely transferred on the stock exchanges and non-tradable shares which cannot. Most state-owned shares and legal-person-owned shares are non-tradable, while shares owned by individuals are tradable. However, recognizing the defects in this distinction, China has been engaged in a reform, known as the 'Equity Division Reform (Gu Quan Fen Zhi Gai Ge),' to make the non-tradable shares tradable starting in September 2005.

Conclusion

To summarize, in both limited liability companies and stock companies the agency problems are almost the same, although the reasons for the problems and the kinds of misconduct may be different.

5.1.1.4 A general review of the protection for minority shareholders provided by Chinese company law

5.1.1.4.1 Sources of Chinese law providing protection for companies and minority shareholders

The major source of Chinese law, which provides protection for companies and minority shareholders, is statutory legislation including the Company Law and the Securities Law. The Company Law regulates issues with regard to corporate governance and provides protection for companies and minority shareholders in general. The Securities Law, through regulations on information, disclosure, and market transparency, etc., also has the effect of protecting stock companies and the minority shareholders therein.

In addition to the statutes, judicial interpretations of the Supreme People's Court (SPC) also play an important role in regulating corporate issues. Judicial interpretations of the Supreme People's Court range from its reply on a specific issue raised by lower courts when hearing a case, to its general guidelines on how to apply a law.[24] Although China is traditionally regarded as a civil-law country and there is no principle of *stare decisis*, the SPC's judicial interpretations are considered as an authoritative source of law in China. There are four regulations which grant the SPC the power to interpret law: 'Decisions on Issues Regarding Interpretation of Law' issued by the Standing Committee of the National People's Congress, the highest legislative body in China, in May 1955; article 33 of 'The Law on the Organization of People's Courts' passed on July 1, 1979; 'The Decision of the Standing Committee of the National People's Congress on Strengthening the Work of the Interpretation of Law' passed on June 10, 1981; and 'The Rules of the Supreme People's Court on the Work of Judicial Interpretation' issued by the SPC on June 23, 1997. The SPC's Rules of 1997 regulate in detail the judicial interpretations' legal effect, drafting procedures, enforcement, tidying up, codification and so on. For example, article 14 of the SPC's Rules holds that when judicial interpretations, together with laws and regulations,

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24 Judicial interpretations can be found in the Gazette of the Supreme People's Court which is the only official publication of the Court and is published several times every year. An English version of the Gazette, as well as the Chinese version, can be found on http://www.isinolaw.com. For a more detailed introduction to judicial interpretations in China, please see Zhai (2002), which also refers to several useful sources of judicial information both in Chinese and in English.

are the basis of a court's judgments (pan jue) or decrees (cai ding), they should be adduced therein.[25] As a result, the judicial interpretations of the Supreme People's Court are legally binding on all lower courts in adjudicating cases unless otherwise specified and are regarded as just as important as the law made by legislative bodies.

Regulations of the China Securities Regulation Committee (the CSRC) also play an important role in protecting the listed companies and minority shareholders therein against the misconduct of controlling shareholders and directors/officers.[26] Since Company Law 1994 and Securities Law 1999 were inefficient in governing the acts of controlling shareholders, as well as directors, and barely provided any protection for minority shareholders, the CSRC has enacted several new regulations in order to supplement these statutes. The nature of the CSRC's regulations may be different. The regulations enacted and issued under the authorization of the State Council are hard law[27], while others are soft law.[28] Nevertheless, the CSRC's soft law is also in practice enforceable since the CSRC may take measures against the companies, such as preventing the companies from listing[29], if they do not follow the soft law. The main regulations of the CSRC have included, for example, 'Provisional Regulations for the Administration of

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25 See SPC's Gazette, Vol. 3 of 1997 (Vol. 51 in general), p. 96. Under Chinese law, a judgment means a court's decision concerning substantive issues of the case and is made when the court closes the case. A decree is a court's decision, which mostly concerns procedural issues of the case, but sometime also concerns substantive issues; a decree can be made at any stage of the case.

26 The CSRC was established in October 1992, as the executive branch of the State Council Securities Committee (SCSC), which was established at the same time. In April 1998, the SCSC and the CSRC were merged to form one unit directly under the State Council, which is the current CSRC. After the reform both the power and the functions of the CSRC were strengthened. Now it is the department authorized to govern the securities and futures markets in China. For a more detailed introduction to the CSRC, please refer to the website of the CSRC: http://www.csrc.gov.cn/en/homepage/about_en.jsp (last visited: May 2006). The regulations of the CSRC I have mentioned here include those issued by the former SCSC; nevertheless, for the sake of convenience, I will not make a distinction.

27 Such as 'Provisional Regulations for the Administration of the Issuing and Trading of Shares' (1993), and 'Provisional Measures on the Prohibition of Securities Fraud' (1993).

28 Such as 'Guidelines for the Articles of Association of Listed Companies' (1997) (amended in 2006), 'General Requirements of the Shareholders Meeting of Listed Companies' (2000) (amended in 2006), 'Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies' (2001), and 'Code of Corporate Governance for Listed Companies' (2002).

29 Before 2000 all companies which were planning on being listed on the stock exchanges had to get the approval of the CSRC. Since March 2001, this approval system has been transformed into a verification system. Under the verification system, the approval of the CSRC is no longer necessary for the company to be listed; nevertheless, the CSRC will still examine and verify the documents for listing which are submitted by the company and, if necessary, disallow the company's being listed. Therefore, practically speaking, the CSRC still has the power to decide whether a company can be listed or not.

the Issuing and Trading of Shares' (1993), 'Implementation Rules for the Disclosure of Information by Companies Issuing Shares to the Public' (1993), 'Provisional Measures on the Prohibition of Securities Fraud' (1993), 'Guidelines for the Articles of Association of Listed Companies' (1997) (amended in 2006), 'General Requirements of the Shareholders' Meeting for Listed Companies' (2000) (amended in 2006), 'Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies' (2001), 'Code of Corporate Governance for Listed Companies' (2002), and 'Regulations for the Protection of Individual Shareholders' Rights' (2004).

5.1.1.4.2 Legal protection for minority shareholders prior to Company Law 2006

5.1.1.4.2.1 General characteristics

Generally, compared with that of majority shareholders and managers, the minority shareholders' position is rather weak in China. On the one hand, there is no mechanism of market controls to protect minority shareholders, even those in listed companies, against the misconduct of majority shareholders and corporate managers. Chinese stock markets are notorious for speculation, disorder, and lack of protection for investors. On the other hand, legal protection for minority shareholders prior to Company Law 2006 was also insufficient. Company Law 1994 barely played any role in preventing misconduct by the controlling shareholders and directors and in protecting minority shareholders. Although there are rules promulgated by the CSRC, which are intended to protect investors in listed companies, these rules are scattered and unsystematic; in addition, they only provide limited and low-level protection. To make matters worse, Chinese courts have been reluctant to hear civil cases arising from misconduct in securities markets.[30]

5.1.1.4.2.2 Company Law 1994

We should take a look at Western law on the issue of providing legal protection for minority shareholders before we examine Company Law 1994, in order to judge the latter better. The Western experience shows that in addition to the basic rights provided to shareholders in general, company law also provides special protection for minority shareholders due to their naturally weak position (mainly caused by the majority rule principle). The shareholders' basic rights are those enjoyed by them in respect to their status as members of the company, the property rights attached to the shares, such as the right of participation in management, the right to profits, and the right to assets upon winding-up, as well as the procedural rights to enforce these rights.[31] Specifically, these include the

30 See Section 5.2.2.3.2.
31 Swart (1996), at p. xii.

right to call and attend the general meeting of shareholders, the right to vote, the right to information, the right to inspect corporate books and records, the right to have the constitution followed, the right to dividends (the right to participation in the profits), the right to remedies when the rights have been infringed upon, and so on. Some of these rights can be enjoyed individually, while others have to be exercised collectively.

However, these basic rights are not sufficient to protect minority shareholders. Company law in Western countries also provides special protection for minority shareholders, which is mainly aimed at preventing the abuse of power by the majority shareholders and/or the management. Generally a plurality of mechanisms has been developed in order to protect the interests of the company and the minority shareholders. Hansmann and Kraakman classify the legal strategies to protect minority shareholders as the appointment-rights strategy, the decision-rights strategy, the trusteeship strategy, the reward strategy, the constraints strategy, and the affiliation-rights strategy.[32] Specifically, the mechanisms include (1) the appointment rights[33]; (2) the decision rights granted to minority shareholders individually or as a group to positively participate in management or negatively block a majority shareholders' decision; (3) rules restricting the power of controlling shareholders, which include *ex ante* prevention of conflict of interest, duties owed by the controlling shareholders to the company and/or the minority shareholders; (4) rules restricting the power of management; (5) *ex post* remedies where the misconduct has already occurred; (6) protection under special circumstances such as change of control (merger), dilution of capital; (7) right to information (including mandatory disclosure).[34]

Company Law 1994 also provided basic rights to shareholders in general. For example, article 4 of the law in principle provided that '[t]he shareholders of a company, as capital contributors, have the right to enjoy the benefits of the assets of the company, make major decisions, choose managers, etc., in accordance with the amount of capital they have invested in the company.' Specifically, the law provided the right to attend the general meeting of shareholders and the right to vote,[35] the right to inspect corporate books and records[36], the right to dividends (the right to participation in profits)[37], the preemption right[38], and the right to remedy when the shareholder's right was infringed upon.[39]

32 Kraakman et al. (2004), at pp. 54-60.

33 Even for minority shareholders it is important to have a board seat, see Kraakman et al. (2004), p. 54.

34 Regulations on information, disclosure, and market transparency, etc., have the side-effect of protecting minority shareholders; see Timmerman & A. Doorman (2004), I.4, 12, pp. 498-499.

35 Articles 37, 41, 102, 106 of Company Law 1994.

36 Articles 32, 110 of Company Law 1994.

37 Article 33 of Company Law 1994.

38 Article 33 of Company Law 1994.

39 Article 111 of Company Law 1994.

However, compared with Western law, the special protection for minority shareholders, especially against the controlling shareholders, was rather weak under Company Law 1994. This was at least partly due to the fact that the law was intended to serve in the reformation of state-owned enterprises. There may also be another reason: Chinese law traditionally has focused more on criminal and administrative fines and penalties than on civil remedies and therefore has neglected to provide protection for minority shareholders.

Several features may be identified as far as special protection for minority shareholders under Company Law 1994 is concerned. First, there were only a few scattered provisions which provided protection for minority shareholders. For example, shareholders representing more than one-fourth of the voting rights in limited liability companies[40] or holding more than ten percent of the shares of stock companies[41] were awarded the right to request that an interim shareholders' meeting be convened. Shareholders representing one-third of voting rights in limited liability companies and shareholders representing one-third of the voting rights of the shareholders, who were present at the general meeting of stock companies, were awarded the right to block important decisions such as alteration of the articles of association, the increase or reduction of registered capital, and the division, merger, dissolution, or transformation of the company.[42] In addition, article 111 granted an individual shareholder the right to action with respect to defective resolutions of the shareholders and/or the boards. However, other mechanisms protecting minority shareholders, such as the right to propose share-older resolutions, the right for a class of shareholders to be entitled to vote separately on issues affecting their own rights, or various remedies such as derivative actions and exit rights for shareholders in limited liability companies, were not provided for.

Second, these few provisions were generally ambiguous and difficult to apply in practice. For example, as mentioned, articles 43 and 104(3) granted a small group of minority shareholders the right to request that an interim shareholders' meeting be convened. However, whether such a group of minority shareholders had the right to convene an interim shareholders' meeting, where the board had refused to do so upon their request, is unclear. Another example is article 111, which I will discuss in detail in Section 5.1.2.1.1.

Third, provisions regarding the director's agency problem did exist, but were not effective in practice. Company Law 1994 recognized the possibility for directors and officers to abuse their power and therefore adopted several mechanisms to discipline the directors and officers. These mechanisms included, for example, the requirement of a supervisory board or supervisors in the company to supervise the board of directors[43]; eligibility requirements for

40 Article 43 of Company Law 1994.

41 Article 104(3) of Company Law 1994.

42 Articles 39, 40, 106 and 107 of Company Law 1994.

43 Articles 52-54, 124-128 of Company Law 1994.

directors (restrictions on who can be a director)[44]; fiduciary duties imposed on directors and managers and liabilities to the company if they have breached their duties and injured the company[45]; and administrative and criminal liabilities in certain situations.[46] However, these mechanisms were not effective in practice. For example, the supervisory board or supervisors did not perform the anticipated task of supervision[47]; directors were rarely held liable for a breach of fiduciary duty.

Fourth, in Company Law 1994 there were almost no restrictions on the controlling shareholders. For example, there were no fiduciary duties, no cumulative voting[48], and no restriction on voting in the case of a related-party transaction.

5.1.1.4.2.3 Other legislation

Theoretically, investors may also rely on other legislation to protect themselves. For example, the PRC's General Principles of Civil Law provides that tort victims are entitled to civil compensation if they have suffered losses.[49] Securities Law also provides that issuers, underwriters and the responsible directors and officers therein should be liable for the investors' losses if there have been false or misleading statements or material omissions in disclosure documents.[50] However, as will be seen in the following section, it may be difficult for the injured investors to seek legal remedies in practice.

5.1.1.4.2.4 The SPC's judicial interpretations

The SPC has played an important role in the legal system by issuing judicial interpretations, which as mentioned are also regarded as an authoritative source of law in China. This role, as far as providing protection for minority shareholders is concerned, may be twofold. On the one hand, the SPC may promote protection for minority shareholders. For example, the SPC acknowledged derivative actions by judicial interpretation even before company legislation had provided for it.[51]

44 Articles 57-58, 123, and 128 of Company Law 1994.

45 Articles 59-63, 123, and 128 of Company Law 1994. We should note that this law did not stipulate that the director owed in general a fiduciary duty to the company.

46 Chapter 10 of Company Law 1994.

47 For a detailed discussion of the function of the supervisory board, please refer to Section 5.1.1.4.3.1.

48 Cumulative voting is a voting system which gives minority shareholders more power by allowing them to obtain representation on the board of directors. Under the regular voting system, a shareholder must vote for a different candidate for each available seat. However, when voting cumulatively, a shareholder can multiply the number of his shares by the number of seats of directors and cast this multiplied number of votes for a single candidate.

49 Such as articles 106 and 117 of the General Principles of Civil Law.

50 Article 63 of Securities Law 1999; article 69 of Securities Law 2006.

51 For a detailed discussion, please refer to Section 5.1.2.1.2.

On the other hand, however, it may reduce protection for shareholders by limiting the injured shareholder's right to suits. Unlike Western courts, which must take all cases that come before them, Chinese courts can first decide whether to accept a case. There is a procedure of docketing (li'an) before the court hears the case.[52] In all levels of Chinese courts there is a li'an division as well as criminal divisions, civil divisions and so on. The plaintiff must bring the case to the li'an division and the li'an division will decide whether to accept the case. All civil cases must meet four requirements in order to be accepted: (1) the plaintiff must be a citizen, legal person or any other organization that has a direct interest in the case; (2) there must be a definite defendant; (3) there must be specific claim(s), fact(s), and cause(s) for the suit; and (4) the suit must be within the scope of acceptance for civil actions by the people's court and lie within the jurisdiction of the people's court where the suit is being filed.[53] If the requirements are met, the li'an division shall li'an (docket the case) within seven days and notify the parties concerned; if the requirements are not met, the li'an division shall reject the case within seven days and the plaintiff, if not satisfied, can file an appeal.[54]

Most disputes as to whether a case should be accepted or not arise from the third requirement, that is, whether there are specific claim(s), fact(s) and cause(s) for the suit. In fact, in order to be accepted the cause of action must be one of those acknowledged by the SPC[55], otherwise, the case will be rejected. Therefore, not all disputes can be heard by the courts. The SPC's judicial interpretations as to misconduct in the securities markets are a good example illustrating this. Although as mentioned investors may initiate civil actions and claim for damages against misconduct in the securities markets according to the PRC's General Principles of Civil Law and/or the Securities Law 1999, the SPC's judicial interpretations have made it practically impossible to do so. In September 2001, the Supreme People's Court issued the 'SPC's Circular on Non-Acceptance of Private Securities Litigation Cases Temporarily.' This judicial interpretation was seriously criticized. As a result, the SPC changed its attitude several months later. On January 15, 2002, the SPC issued 'the Circular on Questions Relating to the Acceptance of Cases Involving Civil Disputes Arising from Infringement of Rights Due to Fraudulent Statements on the Securities Markets' (Circular 2002). This judicial interpretation allowed lower courts to hear civil damages cases where a securities-market investor filed proceedings with a people's court on the grounds that a party with a disclosure obligation violated provisions of the law by

52 It is difficult to find an appropriate translation for the Chinese term 'li'an.' Here I use the English word 'docketing,' which is applied by Clarke D. C. (2002b), p. 13.

53 Article 108 of the PRC's Civil Procedure Law.

54 Articles 111 and 112 of the PRC's Civil Procedure Law.

55 The SPC lists the civil causes of action which will be accepted by courts. See the SPC's Regulations on Civil Causes of Action (Trial Implementation) effective as of January 1, 2001.

making misrepresentations and thereby caused losses to the investor[56], but only in those cases where the CSRC or its agencies had investigated the case and handed down an effective administrative penalty.[57] This Circular has also been criticized for its limited application. Nevertheless, there was no doubt that this Circular has led to progress in protecting investors. Prior to it, the main sanctions for securities violators were criminal and/or administrative ones; there were hardly any civil remedies for the injured company and minority shareholders. Just after the Circular came into effect, many cases were filed against misrepresentation in the securities markets.[58]

Since Circular 2002 was too general to be applied in practice, the SPC issued the revised interpretation with the same title on January 9, 2003, which is effective as of February 1, 2003 (Circular 2003). Circular 2003 is more detailed and easier to apply in practice. At the end of 2003, more than 1600 cases had been accepted by the courts.[59] However, Circular 2003 still limits its application to the securities-markets misrepresentation cases in which there were already a relevant authority's administrative penalty decisions[60] or criminal judgments by a people's court.[61]

5.1.1.4.2.5 The CSRC's regulations

Unlike the SPC's conservative approach to the protection of minority shareholders in securities markets, the CSRC has taken a more aggressive one. It has tried to improve corporate governance in listed companies by issuing regulations which provide more protection for minority shareholders and discipline the conduct of controlling shareholders as well as that of directors and officers. These regulations have played an important role in governing the management of listed companies. They have improved corporate governance in several aspects. First, the CSRC reinforces the minority shareholders' right to participate in corporate management. For example, it specifies that shareholders holding at least ten percent of the company stock have the right to request an interim shareholders'

56 Article 1 of 'The Circular on Questions Relating to the Acceptance of Cases Involving Civil Disputes Arising from Infringement of Rights Due to Fraudulent Statements on the Securities Market,' 2002.

57 Article 2 of 'The Circular on Questions Relating to the Acceptance of Cases Involving Civil Disputes Arising from Infringement of Rights Due to Fraudulent Statements on the Securities Market,' 2002.

58 Since the publishing of Circular 2002 and up until February 2003, at least eleven companies were sued by investors. See Xuan (2003), pp. 114-117. We should note that until this period, the CSRC had made penalty decisions against eighteen listed companies (including intermediate institutions); see Xuan (2003), Appendix 8, pp. 414-416.

59 Hou (2005), 252.

60 Such as the CSRC or the Ministry of Finance.

61 Article 6 of 'The Circular on Questions Relating to the Acceptance of Cases Involving Civil Disputes Arising from Infringement of Rights Due to Fraudulent Statements on the Securities Market,' 2003.

meeting and the right to convene such a meeting if the board of directors does not convene the meeting upon their request.[62] In addition, shareholders holding five percent or more of the voting rights have the right to submit proposals.[63] The CSRC also requires a cumulative-voting system in shareholders' meetings for the election of directors.[64] The individual shareholders' right to participate in the corporate management of listed companies has also been improved. As mentioned, in Chinese listed companies shares are divided into non-tradable shares which are generally owed by the state and legal persons and tradable shares which are generally owned by individual shareholders. Normally the individual shareholders are minorities. Although the rights attached to the two kinds of shares are in practice different, Company Law 1994 did not classify these shares and all shareholders exercised their voting rights without difference. Therefore, the minority individual shareholders may not have the power to decide on issues related to their own rights. In order to protect the minority individual shareholders' rights, the CSRC promulgated the 'Regulations for the Protection of Individual Shareholders' Rights' in 2004, which provides that in the case of the division of shares, according to laws, administrative regulations, and the articles of association, the approval of more than fifty percent of the tradable shareholders who cast their votes must be obtained, in addition to the approval of the general meeting of shareholders, in order to execute or propose certain transactions.[65]

Second, the CSRC had promulgated several regulations to improve shareholder access to information before the enactment of the Securities Law in 1999. These included 'Provisional Regulations for the Administration of the Issuing and Trading of Shares' (1993), 'Implementation Rules for the Disclosure of Information by Companies Issuing Shares to the Public' (1993), and 'Provisional Measures on the Prohibition of Securities Fraud' (1993).

Third, the CSRC has also improved the supervision of the board of directors and officers. On the one hand, it has strengthened the power of the supervisory board, for example, by granting the supervisory board the power to request an interim shareholders' meeting and the power to convene the meeting if the board of directors does not do so upon its request.[66] On the other hand, it has introduced the mechanism of independent directors to ensure that the board will not operate solely in the interests of the directors and/or the controlling shareholders.[67]

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62 Articles 44 and 54 of the CSRC's 'Guidelines for Articles of Association of Listed Companies (1997).' Company Law 1994 only provided such shareholders the right to request an interim shareholders' meeting.

63 Article57 of the CSRC's 'Guidelines for Articles of Association of Listed Companies (1997)'.

64 Article 31 of the CSRC'S 'The Code of Corporate Governance for Listed Companies (2002)'.

65 Article 1(1) of the CSRC's 'Regulations for the Protection of Individual Shareholders' Rights (2004)'.

66 Articles 44 and 54 of the CSRC's 'Guidelines for Articles of Association of Listed Companies (1997)'.

67 The 'Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies 2001'.

Fourth, the CSRC has also adopted several mechanisms to prevent the controlling shareholder's abuse of power and to protect the interests of the listed company and minority shareholders. These mechanisms include the requirement that the shareholder, who has a personal interest in the transaction, cannot vote for it[68], and that the controlling shareholders owe a fiduciary duty to the company and other shareholders.[69] In order to ensure that the management of the listed companies be independent and separate from the influence of the controlling shareholder, the CSRC also requires that personnel, assets and financial affairs of the listed companies should be independent from the controlling shareholders[70], that the controlling shareholder should not give instructions to the listed company[71], and that the controlling shareholder should avoid competing with the listed company.[72]

Although there is no empirical study on it, it is generally agreed that the CSRC's regulations have effectively improved corporate governance in listed companies. In fact, many aspects of the regulations have been incorporated into Company Law 2006.[73]

5.1.1.4.3 The new regulations of Company Law 2006: a better position for the company and minority shareholders

Recognizing the insufficient protection for the company and minority shareholders in Company Law 1994, the Chinese legislature added new regulations to provide better protection in the latest amended Company Law 2006. Many of the protective methods in the CSRC's regulations have also been adopted in the new Company Law and have been extended to protect companies and minority shareholders in general. In addition, Company Law 2006 also contains other protection methods.

5.1.1.4.3.1 Methods of protection in Company Law 2006

Protection methods in Company Law 2006 can be observed from several angles.

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68 Article 72 of the CSRC's 'Guidelines for Articles of Association of Listed Companies (1997); article 34 of the CSRC's 'General Requirements of Shareholders' Meeting of Listed Companies (2000)'.

69 Article 19 of the CSRC'S 'The Code of Corporate Governance for Listed Companies (2002)'.

70 Articles 20-26 of the CSRC'S 'The Code of Corporate Governance for Listed Companies (2002).

71 Articles 22, 26 of the CSRC'S 'The Code of Corporate Governance for Listed Companies (2002).

72 Articles 22, 27 of the CSRC'S 'The Code of Corporate Governance for Listed Companies (2002).

73 See Section 5.1.1.4.3.1.

More rights granted to minority shareholders

Company Law 2006 grants more rights to minority shareholders. First of all, it provides more rights for minority shareholders to participate in corporate management. These rights include, for example, that shareholders representing more than one-tenth of voting rights (for a continuous ninety days in stock companies) may convene and preside over the shareholders' meeting at their own discretion if the supervisory board or the supervisors fail to do so,[74] that in stock companies shareholders who aggregately own more than three percent of shares have the right to submit proposals to the shareholders' meeting[75], and that in stock companies shareholders representing more than one-tenth of the voting rights have the right to propose a convening of an interim meeting of the board of directors.[76] In addition, minority shareholders may have more of a voice in corporate management. In limited liability companies, shareholders may not exercise their voting rights in the shareholders' meeting in proportion to their capital contributions if the articles of association of the company so provide[77]; in stock companies, when electing directors or supervisors, the cumulative voting system may be applied in accordance with the provisions of the articles of association or the resolution of the shareholders' general meeting.[78]

Second, shareholders are granted more rights to information. These rights are especially important for minority shareholders who normally are unable to take part in corporate management. The rights include (1) the shareholders' right to check and review corporate documents such as the articles of association of the company, the register of the shareholders, the corporate bond counterfoils, the meeting minutes of the shareholders' general meeting, the resolutions of the board of directors, the resolutions of the board of supervisors, and the financial and accounting reports[79]; and (2) the directors and senior officers' duty to answer any inquiry by shareholders in the shareholders' general meeting.[80]

Third, minority shareholders are granted more *ex post* remedies. (1) The individual shareholder's right to initiate actions against defective resolutions of the corporate bodies has been improved in several respects: the right has been extended to shareholders in limited liability companies; the defective resolutions have been divided into void and voidable ones; violation of the articles of association in addition to the violation of law and regulations now also makes the

74 Articles 41 and 102 of Company Law 2006.
75 Article 103 of Company Law 2006.
76 Article 111 of Company Law 2006.
77 Article 43 of Company Law 2006.
78 Article 106 of Company Law 2006.
79 As to this shareholders' right in limited liability companies, please compare article 34 of Company Law 2006 with article 32 of Company Law 1994; as to the right in stock companies, please see article 98 of Company Law 2006.
80 Article 151 of Company Law 2006.

resolution voidable; and restrictions have been placed on the shareholder's right to challenge defective resolutions in order to prevent abusive use of such a right, for example, the shareholder must now bring the action within sixty days of the date of making the resolution and the court may, upon the request of the company, require the shareholder to provide security.[81] (2) Minority shareholders have also been granted the right to initiate direct or derivative actions for compensation.[82] (3) An exit right has been provided for shareholders in limited liability companies under certain circumstances. However, minority shareholders in limited liability companies are not granted the exit right where they are oppressed by majority shareholders, a situation where the minority shareholders may really need an exit right.[83] (4) Minority shareholders are also awarded the right to require the court to dissolve the company. Article 183 stipulates that:

> If serious difficulties arise in the operation and management of a company and its continued existence would cause a material loss to the interests of the shareholders and the difficulties cannot be resolved through other means, shareholders holding at least 10% of all shareholder voting rights may petition a people's court to dissolve the company.[84]

The ex ante prevention of conflicts of interest

Company Law 2006 also notes the importance of *ex ante* prevention of conflicts of interest between the company and its shareholders, directors or officers. First, it keeps and further develops the requirement that certain conduct of the directors and officers, such as entering into contracts or conducting transactions with the company or providing security for a third party using corporate assets, should be allowed by the articles of association or permitted by the shareholders' meeting.[85] Second, it stipulates in several articles that the related party, including shareholders and directors, is forbidden to vote under certain circumstances. For example, as far as the shareholders are concerned, article 16 requires that where the shareholders' meeting makes a decision to provide security for its shareholders or *de facto* controllers, such shareholders or the shareholders under the control of the *de facto* controllers shall not be allowed to vote for the decision.[86] Directors may not vote either in certain situations. Article 125 provides that a

81 Article 22 of Company Law 2006.

82 Articles 152 and 153 of Company Law 2006. For a detailed discussion of the direct and derivative actions, please refer to Sections 5.3 and 5.4.

83 Article 75 of Company Law 2006. For the content of the article, please refer to Section 5.2.2.2.

84 The English version of Chinese Company Law 2006 in this book is cited from China Law & Practice, December 2005/January 2006, Vol. 19, No. 10, published by Asia Law & Practice, Hong Kong, pp. 21-71.

85 Please compare articles 60 and 61 of Company Law 1994 with article 149 of Company Law 2006.

director in a listed company cannot vote if he has an affiliate relationship with the enterprise related to the matter to be decided, nor can he vote on behalf of other directors. As will be seen later, article 152, which governs the shareholders' derivative actions, also embodies the rationale of *ex ante* prevention of conflict of interest.

Improving the functioning of the supervisory board or the supervisors

The ineffective functioning of the supervisory board or the supervisors had been seriously criticized before enactment of Company Law 2006. The criticism was mainly focused on two aspects. First, the supervisory board was criticized for being too dependent to exercise its function freely. As mentioned in Section 5.1.1.2, the supervisors are elected either by shareholders or employees. However, the supervisors elected by shareholders, just like the directors, are normally controlled by the majority shareholders; while the employee supervisors generally will not challenge the controlling shareholders and/or the directors either since they are afraid of losing their jobs. In addition, in working together with directors, Chinese supervisors generally will not sue their colleagues due to Chinese cultural tradition.

The second aspect of the criticism was that the supervisory board or the supervisors were not granted sufficient power to enforce their supervisory function. Although Company Law 1994 granted the supervisory board or the supervisors the power to examine the financial affairs of the company, the power to supervise the acts of the directors and senior executives performing their functions, the power to demand directors and senior executives make corrections if any of their acts is found to have damaged the interests of the company, and the power to propose the convening of interim shareholders' meetings[87], these powers were far from enough for the supervisory board or the supervisors to perform their function.

Company Law 2006 tries to improve the functioning of the supervisory board or the supervisors. Nevertheless, the effort at improvement mainly focuses on the second aspect rather than the first. The new amended law grants more power to the supervisory board or the supervisors, but unfortunately leaves the problem of dependence almost untouched. While keeping the powers granted in Company Law 1994[88], Company Law 2006 adds more powers to the ones the supervisory board may exercise. These include the power 'to bring the proposal to dismiss those directors and senior executives violating the laws, administrative regulations, the articles of association of the company or the resolutions of the

86 Nevertheless, a general requirement that a shareholder may not vote in the shareholder's meeting in cases of a related-party transaction is not stipulated in Company Law 2006.

87 Articles 54, 126 of Company Law 1994.

88 Articles 54, 119 of Company Law 2006.

shareholders' meetings'[89]; the power 'to convene and preside over the shareholders' meetings in case the board of directors fails in its function of convening and presiding over the shareholders' meetings as provided by this Law'[90]; the power 'to bring a proposal to the shareholders' meetings'[91]; the power 'to bring a lawsuit against the directors or senior executives in accordance with the provisions of article 152 of this Law'.[92] The supervisory board may also 'bring enquiry and suggestion on the matters decided by the board of directors,' or may, 'in case of finding the business situation of the company abnormal, conduct an investigation, and, if necessary, may engage any accountant's firm to assist its work at the expenses of the company'.[93] However, these powers will only be paper tigers if the supervisors remain dependent.

Reinforcing the duty of directors (including supervisors) and senior officers

An important improvement of Company Law 2006 is that it reinforces the duty of directors (including supervisors) and senior officers. In addition to the specific duties imposed on directors (including supervisors) and senior officers[94], Company Law 2006 asserts that they generally owe a duty of loyalty and duty of care towards the company.[95] If they breach their duty and injure the company or the shareholders, they will be held liable to the company or the shareholders, and minority shareholders can bring direct or derivative actions for compensation.[96]

Imposing duties on the shareholder in regard to the company and other shareholders

Recognizing that the conflict between majority and minority shareholders is one of the major agency problems in Chinese companies, the legislature tried to regulate the issue under Company Law 2006. Company Law 2006 imposes duties on any shareholder in regard to the company and other shareholders, and makes the shareholder liable to pay compensation if he breaches these duties. The duties are mainly regulated by two articles. Article 20 states that:

> A company shareholder shall comply with laws, administrative regulations and the company's articles of association, exercise his or her shareholder rights in accordance with the law, and shall not abuse his or her shareholder

89 Articles 54(2), 119 of Company Law 2006.
90 Articles 54(4), 119 of Company Law 2006.
91 Articles 54(5), 119 of Company Law 2006.
92 Articles 54(6), 119 of Company Law 2006.
93 Articles 55, 119 of Company Law 2006.
94 Articles 21, 148 and 149 of Company Law 2006.
95 Article 148 of Company Law 2006.
96 Articles 21, 150, 152 and 153 of Company Law 2006. For details on the shareholder's direct and derivative actions, please refer to Sections 5.3 and 5.4.

> rights to harm the interests of the company or those of other shareholders…
> If a company shareholder abuses his or her shareholder rights, thereby causing the company or other shareholders to incur a loss, he or she shall bear liability for damages in accordance with the law.
> …

Article 21 states that:

> A company's controlling shareholder, *de facto* controller, director, supervisor, or senior officer shall not use his or her affiliated relationship to harm the interests of the company.
> If such a person violates the preceding paragraph, thereby causing the company to incur a loss, he or she shall be liable for damages.'

However, the articles may be paper tigers. First, they are too general to apply in practice. Company Law 2006 is silent as to the contents or the standards of these duties; besides, there has been no case brought regarding these duties. Second, enforcement of the duties may also be difficult. On the one hand, where a shareholder breached his duty owed to the company and caused damage to the company, the company certainly can sue for damages; however, whether minority shareholders can bring a derivative action against the wrongdoing shareholder in such cases is still uncertain.[97] Nevertheless, the minority shareholders' right to derivative actions against the wrongdoing shareholder is important since in most cases the wrongdoing shareholder controls the company and it is hardly possible for the company to bring an action against him otherwise. On the other hand, where a shareholder has breached his duty owed to other shareholders, there is no regulation in Company Law 2006 which explicitly grants the injured shareholder the right to sue for breach. This is different from the breach of duty by directors. Where a director or senior officer breaches his duty owed to individual shareholders, article 153 of Company Law 2006 explicitly grants that injured shareholder the right to sue.[98] This lack of any explicit litigation right may prove a disadvantage for the injured shareholder, considering the docketing (li'an) system under Chinese law.

These articles have another defect of not providing sufficient remedies for breach of shareholder's duties. If the articles are understood literally, compensation may be the only remedy. However, for the injured shareholders, especially those in limited liability companies, compensation may not be sufficient; other remedies such as an exit right may be important as well.

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97 Article 152 of Company Law 2006. For a detailed discussion on this uncertainty, please refer to Section 5.4.1.1.

98 See Section 5.3.2.

Imposing a duty on the de facto controller of the company

A characteristic of Company Law 2006 is that it imposes duties on the *de facto* controller of the company in certain situations. Article 16 requires that where the company provides security to the *de facto* controller of the company, such security should be decided by the shareholders' general meeting; the shareholders controlled by the *de facto* controller should not vote on the decision. Article 21 states that the *de facto controller*, as well as the controlling shareholders, directors, supervisors and senior officers, shall not infringe on the interests of the company by taking advantage of his affiliate relationship; otherwise, he should be held liable for compensation.

According to Company Law 2006, the *de facto* controller is the person 'who is not a shareholder of a company but can control the company's acts through investment relationships, agreements or other arrangements'.[99] Taking into account that the problem of the *de facto* controller is a serious one in Chinese companies, the regulations in the new amended company law are necessary and will provide better protection for companies and minority shareholders if they are well enforced.

5.1.1.4.3.2 Defects of Company Law 2006

Undoubtedly Company Law 2006 improves many aspects of corporate governance and provides more protection for the company and minority shareholders. However, it still has its defects. To name just a few, the first is the technical problem that the regulations in the law are scattered and unsystematic. For example, Chapter 6 regulates eligibility requirements and duties of directors, supervisors and senior officers while at the same time the articles regulating shareholders' duties are found in Chapter 1 of 'the general provisions.' More ironically, article 21 repeatedly stipulates that the company's controlling shareholders, *de facto* controllers, directors, supervisors and senior officers cannot infringe on corporate interests through affiliated transactions. Another example is that the shareholders' right to set aside the defective resolutions of corporate bodies is regulated in Chapter 1 of 'the general provisions' while at the same time Chapter 6 also regulates shareholders' rights to direct and derivative actions. Second, the duties owed by shareholders, directors (including supervisors) and officers to the company and/or other shareholders, especially the shareholder's duties, are still not clear and enforcement of the duties is doubtful.[100] Of course, we also acknowledge that it is not wise for the corporate statute to clearly define the duties *ex ante* and that this task should be left to the courts. Therefore, the effect of the rules is still to be seen, and this to a great extent depends on the

99 Article 217(3) of Company Law 2006.

100 See, for example, Section 5.2.2.3.1 as to the court's ability to hear derivative actions.

operation of the Chinese judicial branch. Third, the role of the supervisory board or the supervisors is still a doubtful one. Although more power is granted to the supervisory board or the supervisors by the new law, the problem of lack of independence of the supervisory board is still not solved. Without independence, the supervisory board cannot perform its role well no matter how many powers it has.

5.1.2 The development of derivative action in China

After a discussion of the Chinese background behind the derivative action, we can now take a look at the development of the derivative action itself in China. This development can also be divided into two phases: development prior to Company Law 2006 and development after that.

5.1.2.1 The development prior to Company Law 2006

5.1.2.1.1 Article 111 of Company Law 1994

Article 111 was the only article in Company Law 1994 which granted shareholders the right to initiate actions against corporate misconduct. It was of significance in the sense that it granted individual shareholders the right to seek for judicial remedies. The article provided that:

> If any resolution adopted by a shareholders' general meeting or the board of directors violates any statute or administrative regulation, infringes legal rights and interests of shareholders, the shareholders are entitled to initiate a proceeding to the people's court to require that such acts of violation or infringement be stopped.

However, this article only provided limited protection for the company and minority shareholders. It only applied to stock companies since the article was in the chapter on 'Establishment and Organizational Structure of Stock Companies.' In addition, literally, the remedy that the plaintiff shareholder could acquire under the article was only an injunction: compensation might well not be granted. Furthermore, the article was too general and obscure to be applied in practice. For example, it was not clear what the 'legal rights and interests of shareholders' were; besides, there were no regulations regarding the procedure for applying the article.

Another dispute regarding the article was whether the article granted minority shareholders the right to initiate derivative actions. The dispute arose from the ambiguous wording of the article. In its original Chinese version, there was only a comma between the condition of violating any statute or administrative regulation (the condition of 'violation') and the condition of infringing legal rights and interests of shareholders (the condition of 'infringement'). Therefore, whether both of the conditions had to be met in order for the shareholder to

pursue an action or whether either one or the other of the conditions was sufficient was questionable. The majority view in practice was that both of the conditions had to be met; therefore, the article did not grant the shareholder the right to initiate derivative actions. However, there was also a minority view, which held that the article included a right to derivative actions[101] or should be broadly interpreted to include such a right.[102]

5.1.2.1.2 The application of derivative action by the courts

5.1.2.1.2.1 Practical problems faced by Chinese courts: the necessity for introducing the mechanism of derivative action

Although Company Law 1994 did not explicitly grant a shareholder the right to initiate a derivative action, such a right may be a practical necessity. As mentioned, where there is the general principle that an action against a corporate wrong should be brought by the injured company, derivative actions are necessary in order to protect the company and the shareholders' interests in exceptional cases. This general principle has also been established in Chinese law. Article 108(1) of Chinese Civil Procedure Law stipulates that 'the plaintiffs must be citizens, legal persons and/or other organizations which have a direct interest in the case,' and article 3 of Chinese Company Law 1994 recognized companies as legal persons. As a result, according to Chinese law, when misconduct has been done to a company, only the company can be the proper plaintiff because only the company has a direct interest in the case. Since there was no specific regulation in Company Law 1994 with regard to which corporate body was granted the power to make a corporate litigation decision, either the board of directors or the general meeting of shareholders might make such a decision. However, article 49 of Chinese Civil Procedure Law requires that 'a legal person shall be represented by its legal representative in the proceedings.' According to articles 45, 68 and 113 of Company Law 1994, the chairperson of the board of directors was the legal representative of the company. Thus, in the case of a wrong done to the company, if the board of directors or the general meeting of shareholders has decided not to bring an action against the misconduct, or the chairperson of the board of directors has refused to represent the company in the action, the wrong done to the company might not be redressed and therefore the derivative action might prove necessary.

This legislative situation had caused problems in practice. In China, both in limited liability companies and stock companies, it was a serious problem that majority shareholders and/or directors, sometimes colluding with third parties, infringed on the interests of the company and minority shareholders. Without the derivative action, the interests of the company and minority shareholders could

101 Kong (1996), pp. 248-250.

102 Zhao (1998), p. 258.

not be redressed. For example, in the cases of *Zhongtian v. Bichun, etc.*, the controlling shareholder of Yanzhong Company established two subsidiaries which unfairly competed with Yanzhong Company. Because Yanzhong Company was controlled by the controlling shareholder, it did not bring an action against the controlling shareholder's two subsidiaries, although another shareholder of Yanzhong, Zhongtian, required it to do so. As a result, Zhongtian filed two separate claims in its own name with the No. 1 and No. 2 Intermediate People's Courts of Shanghai against the controlling shareholder and its subsidiaries. Nevertheless, both cases were dismissed due to lack of legal provisions on derivative action and other defects within the Company Law.

In order to protect the interests of the company and minority shareholders, Chinese courts began applying the mechanism of derivative action when adjudicating cases. In fact, although Company Law 1994 was silent on the issue, Chinese courts have played an important role in developing the mechanism of derivative action.

5.1.2.1.2.2 The judicial application of derivative action

The SPC's judicial interpretation in 1994 (a partial recognition of derivative action)

On November 4, 1994, in its judicial interpretation of 'Reply of the Supreme People's Court concerning in whose name the Chinese party of a Sino-Foreign equity joint-venture company should file a suit with the People's court where the joint-venture company has external economic contract disputes, and the controlling foreign party of the joint-venture company has interests with the seller'[103], the Supreme People's Court of the PRC partially recognized that where a company was not able to bring an action to redress its damages, its shareholders should be awarded the right to sue. This judicial interpretation was based on a case heard by the High People's Court of Jiangsu Province. In this case (hereinafter referred to as the *Zhang Jia Gang* case), a Chinese factory (named as Zhang Jia Gang Terylene Long Silk Factory, hereinafter referred to as 'the Chinese party') and a Hong Kong private company (named as Hong Kong Jixiong, a limited liability company, hereinafter referred to as 'the Hong Kong party') entered into a Sino-Foreign equity joint-venture contract and established a Sino-Foreign equity joint-venture limited liability company (named as Zhang Jia Gang Jixiong Chemical Fiber Limited Liability Company, hereinafter referred to as 'the Joint-Venture Company')[104], of which the Hong Kong party was the controlling shareholder. The Joint-Venture Company, as the purchaser, entered into a sales contract with a third party who was the seller. Both in the joint-

103 Fa Jing [1994] No. 269; see SPC (2004), p. 430.

104 According to Chinese law, Hong Kong investors are treated in the same way as foreign investors are.

venture contract and in the sales contract there were arbitration clauses. Later, disputes arose about the sales contract, and the purchaser's interests were injured by the seller. Since the Hong Kong party, which controlled the Joint-Venture Company, had direct interests with the seller, it refused to convene a meeting of the board of directors of the Joint-Venture Company in order to decide to sue the seller. As a result, the interests of the Joint-Venture Company could not be redressed, and as a result the Chinese party's interests were infringed upon as well. The Chinese party filed the case with the High People's Court of Jiangsu Province. However, since there was no mechanism of derivative action in Chinese law then, the High People's Court of Jiangsu Province was not sure in whose name the Chinese party should file the case. Hence, it raised the question before the Supreme People's Court.

In its Reply, the Supreme People's Court acknowledged that in this case, if there had been no arbitration clauses in the joint-venture contract and the sales contract, the Chinese party would have been entitled to file a suit when the board of the Joint-Venture Company did not do so and the court should have accepted such a case. Nevertheless, due to the existence of arbitration clauses, the dispute then had to be submitted to arbitrators and so the court was not the one to hear the case. From the Reply, we can see that the Supreme People's Court accepted the idea of derivative actions, although the terminology of 'derivative actions' was not used, nor were any further details illustrated. However, the effect of this Reply on future judicial decisions was limited because it was about a specific case of a Sino-foreign equity joint-venture enterprise: in China, special laws and principles may apply to foreign investment companies but not to other companies. The Reply was regarded as only applying to the same situation as the *Zhang Jia Gang* case, that is, those situations where the interests of a Sino-foreign joint-venture enterprise and the Chinese party of the enterprise had been infringed. This might explain why the above-mentioned case of *Zhongtian v. Bichun*, which happened after the *Zhang Jia Gang* case in 1996, was dismissed: in the case of *Zhongtian v. Bichun*, it was the interests of the joint-venture company and the foreign party rather than the Chinese party that had been infringed.

Cases decided by local courts

Although the two cases filed by Zhongtian were dismissed by the No. 1 and No. 2 Intermediate People's Courts of Shanghai, some local courts did begin applying the mechanism of derivative action to adjudicate cases, even if the situations of the cases were different from that of *Zhang Jia Gang*. At the outset, the derivative suits accepted by the courts concerned limited liability companies such as the *Xin Jiangnan* case, decided by the Intermediate People's Court of Wuxi City of Jiangsu Province in 1998[105]; the *Huafeng* case, decided by Xiangzhou District

105 SPC's Gazette, Vol. 6 of 2001 (in general Vol 74), pp. 213-214.

People's Court of Zhuhai City of Guangdong Province in 2000[106]; the *Wu Fang Zhai* case, decided by the Intermediate People's Court of Jiaxing City of Zhejiang Province in 2001[107]; and the *Zhong Qi Qi Huo* case, decided by the High People's Court of Beijing in December 2005.[108] The disputed amount in some of the cases was very large. For example, in *Zhong Qi Qi Huo* case, the disputed amount was about 164 million Chinese RMB (about EUR 16.4 million).[109]

The courts were more conservative as to derivative actions regarding listed companies. On April 8, 2003, an individual shareholder of Sanjiu Medical and Pharmaceutical (referred to as Sanjiu hereafter), a company listed on the Shenzhen Stock Exchange, filed a derivative action against the chairman of Sanjiu with Shenzhen Futian District People's Court, claiming that the chairman should compensate Sanjiu for losses suffered due to the chairman's misconduct.[110] The case was not accepted and the plaintiff filed with the Intermediate People's Court of Shenzhen a few days later. Nevertheless, the Intermediate People's Court of Shenzhen again dismissed the case, stating that the plaintiff should acquire the authority of all the shareholders before initiating the case since the derivative action represented the interests of all the shareholders.[111] Although the plaintiff shareholder tried to justify his action by citing the speech of Li Guoguang, the then associate chief justice of the SPC, given on December 11, 2002, which stated that the people's court should accept the suit filed by the shareholder against the controlling shareholder or against senior management's infringement on the company, the Intermediate People's Court of Shenzhen disagreed with this plaintiff's argument and held that the speech was only a reference point and could not be used as a legal basis for accepting the case.[112] Therefore, although many derivative actions regarding limited liability companies had long been accepted by various local courts, this first derivative action regarding listed companies was still refused.

However, about one year later, another derivative claim filed by an individual shareholder regarding a listed company named Lianhua Weijing, jointly with the plaintiff's direct claims, was accepted by Daqing Ranghulu District People's Court.[113] This case was regarded as a significant step towards derivative actions. However, the result of the case is unknown.

To summarize, neither corporate statute nor the SPC introduced the mechanism of derivative action in general before the implementation of Company Law 2006.

106 Wang T. (2001).
107 Lu (2001), p.14; Yang (2001), p. 5.
108 Wang N. (2006).
109 Wang N. (2006).
110 Xu (2003).
111 Wang L. (2003).
112 Wang L. (2003).
113 Wang L. (2004).

However, Chinese courts, including the SPC, had to a certain extent tried to apply the principle to protect the interests of the injured company and minority shareholders. This effort occurred step by step. Nevertheless, since there was no legislation or general guidelines from the SPC on them, the application of derivative actions was in a state of chaos. Some courts accepted the cases, while others refused the cases. The courts, which did accept the cases, also took different approaches to important issues such as the prerequisites of bringing the cases.

Nevertheless, there are several common issues which might be revealed by these cases. First, most of the cases brought to court concerned limited liability companies rather than listed companies. Second, in most of the cases, the conflict was between majority shareholders and minority shareholders.[114] Third, in most of the cases, the defendants were the majority shareholders and/or those who directly committed and benefited from the misconduct, be it unfair competition or conflict dealing. Directors who had not benefited from the misconduct normally would not be sued for their breach of duty in assisting the misconduct or in failing to initiate corporate litigation against the misconduct.

Judicial opinions on the application of derivative action

With more and more derivative action cases in practice, the courts felt the necessity to explicitly acknowledge the mechanism of derivative action and to have guiding rules on how to apply this mechanism. High people's courts in several provinces and municipalities, such as Zhejiang Province in 2002[115], Shanghai in 2003[116], Jiangsu Province in 2003[117], and Beijing in 2004[118], respectively, promulgated judicial opinions which had a guiding effect on lower courts under their jurisdictions. Some opinions simply acknowledged that

114 In fact, even in listed companies, it is very common for the majority shareholders to infringe on the company's interests.

115 No. 2 Civil Division of the High People's Court of Zhejiang Province, Zhejiangsheng Gaojirenminfayuan Minshi Shenpan Di'erting Guanyu Gongsifa Shiyong Ruogan Yinan Wenti de Lijie [No. 2 Civil Division of the High People's Court of Zhejiang Province Understandings on Several Difficult Issues Regarding the Application of the Company Law], December, 2002, article 15.

116 No. 2 Civil division of Shanghai High People's Court, Guanyu Shenli Sheji Gongsi Susong Anjian Ruogan Wenti de Chuli Yijian (yi) [The Opinions on Adjudicating Cases Regarding Corporate Litigations (No. 1)], issued in June, 2003, article 5.

117 The High People's Court of Jiangsu Province, Jiangsusheng Gaojirenminfayuan Guanyu Shenli Shiyong Gongsifa Anjian Ruogan Wenti de Yijian (Shixing) [The Opinions of the High People's Court of Jiangsu Province on Several Issues on Adjudicating Cases Applying the Company Law (Trial Implementation), issued in June, 2003, articles 17, pp. 73-78.

118 Beijing High People's Court, Beijingshi Gaojirenminfayuan Guanyu Shenli Gongsi Jiufen Anjian Ruogan Wenti de Zhidao Yijian (Shixing) [The Guiding Opinions of Beijing High People's Court on Several Issues on Adjudicating Corporate Disputes Cases (Trial Implementation), issued in February, 2004, article 1(8).

derivative action cases should be accepted[119], while others specified several rules for applying the mechanism of derivative action.[120]

In November 2003, the Supreme People's Court also published 'Regulations on Several Issues of Adjudicating Corporate Disputes Cases (I), (the Draft for Soliciting Opinions)'[121], which included five articles concerning derivative action. Article 43 concerned the nature of a liability which could be challenged through a derivative action. Article 44 stated the standing criteria for bringing a derivative action. Article 45 provided that in order to file a derivative action, the plaintiff must first prove certain facts. Article 46 was concerned with the status of other parties in the suit, such as other shareholders who also filed an action, colluders, and the injured company itself. And article 47 was about ordering the plaintiff to post security for costs in certain situations. Nevertheless, no further steps were taken since it was expected that Company Law 1994 would soon be amended. Although the SPC's Regulations were only a draft and had no effect in judicial practice, they did demonstrate the effort on the part of the SPC to unify the rules on derivative suits.

5.1.2.2 The stipulation in Company Law 2006

Judicial development in China has shown that it was an inevitable trend for Company Law 2006 to adopt the mechanism of derivative action. As expected, article 152 of Company Law 2006 grants minority shareholders the right to initiate derivative actions.[122] The article has been widely welcomed and regarded as making significant progress towards protecting the interests of the company and minority shareholders. However, there are also defects in the article, which I will discuss later. Due to these defects, the effect the article will have in practice is still difficult to predict.

5.2 The role of derivative action in China

5.2.1 Prior to Company Law 2006

As mentioned above, although there was no legislation on derivative actions prior to Company Law 2006, Chinese courts had already applied the mechanism of derivative action to adjudicate cases. In fact, since there were hardly any market controls on corporate management and Company Law 1994 provided few mechanisms to discipline corporate management and to protect the interests of

119 Such as Beijing and Jiangsu.
120 Such as Shanghai and Zhejiang.
121 http://www.civillaw.com.cn/weizhang/default.asp?id=13334 (last visited: November 6, 2003).
122 For the details of the article, please refer to Section 5.4.

the company and minority shareholders, the derivative action, as an *ex post* legal remedy, should have been an important solution for aggrieved minority shareholders.

Nevertheless, the role of the derivative action was limited. The judicial application of derivative action was in a state of disorder, in bits and pieces, unsystematic, in disunity, and not anticipatable. Minority shareholders could not actually rely on the principle to protect themselves and the company; instead, they felt more as if they were simply lucky if the derivative suit was accepted and the misconduct rooted out.

Another aspect of the limited role of derivative action was its restricted application. The cases already decided showed that derivative actions were mainly applied to resolve the conflicts between majority shareholders and minority shareholders in limited liability companies. On the one hand, directors were barely held liable even if they colluded with the wrongdoing majority shareholder. On the other hand, Chinese legislators and courts took a very conservative attitude towards actions regarding listed companies, including derivative actions. This approach was at least partly due to the complexity of such actions and the public influence they had. The only generally accepted corporate actions involving listed companies were, as mentioned in Section 5.1.1.4.2.4, actions against listed companies on grounds of false statements, which are shareholders' direct actions. Nevertheless, we should notice that to a certain extent the CSRC's regulations played the role of disciplining corporate management and protecting listed companies and minority shareholders therein.

5.2.2 *After Company Law 2006*

As mentioned, Company Law 2006 is intended to improve corporate governance across the board. It provides both *ex ante* and *ex post* mechanisms for disciplining corporate management and protecting the interests of the company and minority shareholders. Derivative action is just one of these. In fact, Chinese legislators, judges, scholars and legal practitioners agree unanimously that the derivative action is an important mechanism and should play an important role in corporate management. However, will derivative action play that anticipated role in China? Will Chinese special circumstances affect the application of the derivative action in China? These are very difficult questions and currently there may be no satisfactory answers to them. Nevertheless, it is also not appropriate for us to simply ignore the questions since we might then misunderstand the role of derivative actions in China. Therefore, in this section I will briefly discuss these issues.

5.2.2.1 *Lack of market controls on corporate management*

It is widely agreed that there are no market controls on corporate management in China due to factors such as a lack of negotiability of a certain percentage of shares, a lack of a managers' market and the serious problem of speculation in the

securities markets (the prices of shares do not reflect the performance of the company and the markets are considered worse than gambling casinos). Although the Chinese government is trying to solve some of these problems, such as by promoting the negotiability of shares, this situation of a lack of market controls will take more than just a short period of time to change. As a result, this lack of market controls makes derivative actions important even for listed companies.

5.2.2.2 *The influence of legal rules and norms*

Comparative study leads us to acknowledge the fact that legal rules and norms will affect the application of derivative actions. Firstly, specific legal rules on derivative actions such as the standing criteria and the prerequisite procedure will directly affect the application of derivative actions. How to construct specific rules depends on the legislature's attitude towards the function of derivative actions. Many factors such as the economic and legal environment will influence the legislature's attitude. Secondly, some legal rules which do not specifically regulate derivative actions do at the same time have a direct influence on derivative actions, such as litigation fees, the shareholder's access to information, the security required for the litigation, and alternative remedies, which include removal of directors, injunctions, settlement, and the right of exit. West calls them 'extrasystemic legal rules'.[123] Thirdly, a broader group of legal rules, including rules on corporate governance, will also affect derivative actions; for example, a better *ex ante* prevention of mismanagement will reduce the necessity for *ex post* remedies.

Will the first and second groups of rules in Company Law 2006 and other laws support an active role for derivative actions in China? The answer may be negative, especially for derivative actions initiated by minority shareholders in listed companies. I will discuss these rules in detail in Section 5.4. Here I will consider the third group of legal rules, especially the influence of alternative mechanisms on derivative actions. As we know, if there are sufficient effective alternative mechanisms, there may be less need for derivative actions. When this is not the case, aggrieved shareholders have to turn to derivative actions in order to protect themselves.

As mentioned, Company Law 2006 tries to improve corporate governance as a whole by providing and improving several mechanisms in addition to derivative actions. Nevertheless, the effect of these mechanisms is still unknown. The effect will most certainly depend on the enforcement of the statute, which may not be satisfactory. For example, although Company Law 2006 provides more power to the supervisory board, with the aim of improving its supervisory function, it is still doubtful whether that aim will be achieved due to problems such as supervisors' dependence. Another example is that Company Law 2006 acknowledges

123 West (1994), p. 1443.

the importance of *ex ante* prevention of conflict of interest and then goes on to forbid the related party voting in certain situations. However, it may be problematic to define this related party: too broad a definition may negatively affect ordinary business; while too narrow a definition may not have the anticipated effect, especially considering the fact that cross holding is very common and that China is a 'relationship' (Guan Xi) society.

Ex post remedies for aggrieved shareholders afforded by Company Law 2006 are also limited. For example, the duty owed by a shareholder to the company and other shareholders is not clear and is difficult to enforce.[124] It is also difficult for minority shareholders in limited liability companies to have the harm done to them redressed by exercising an exit right. In limited liability companies, 'a shareholder who votes against a relevant resolution at a meeting of the shareholders may request that the company purchase his or her equity at a reasonable price' only if

> (1) the company has not distributed profits to the shareholder for five consecutive years where the company has been profitable during those five years and the shareholder satisfies the conditions for the distribution of profits specified in this Law;
> (2) the company merges, is divided, or transfers its main property; or
> (3) the term of operation specified in the company's articles of association expires or other grounds for dissolution as specified in the articles of association arise and the shareholders' meeting resolves to amend the articles of association to extend the life of the company.[125]

Thus, most situations where majority shareholders abuse their rights and then infringe on the interests of the company and/or minority shareholders are excluded. In addition, there is no clue at all as to how 'a reasonable price' will be calculated.

As a result, derivative actions may still be important since other mechanisms provided in Company Law 2006 may not work well, at least for a period of time.

5.2.2.3 The influence of Chinese special situations

Chinese special situations may also affect the application of derivative actions. Here I will discuss the most obvious of these situations.

5.2.2.3.1 The court's ability to hear derivative cases

As the comparative study shows, courts have been playing an important role in derivative actions. Derivative actions involve balancing the interests of the

124 Articles 20 and 21 of Company Law 2006.
125 Article 75 of Company Law 2006.

different parties, and it is difficult to have fixed rules that can anticipate all situations and strike a fair balance beforehand. Therefore, the court's discretion is necessary. For example, the standard of fiduciary duty and the decision as to whether to allow a derivative action both involve the court's discretion to a large extent. In fact, there is a convergence in the countries we have studied showing that the court has come to play a more important role in derivative actions.

However, Chinese courts may not be competent to fulfill such an important task. Chinese courts are notorious for many problems such as the dependence and the poor quality of judges. For example, it is well known that Chinese courts are dependent on local governments and tend to protect the interests of local governments. According to Chinese Civil Procedure Law[126], the derivative action may be under the jurisdiction of the court where the defendant has his domicile. Therefore, wrongdoing directors or controlling shareholders, especially where they are appointed by state-owned enterprises or are state-owned enterprises, may be under the protection of the local courts.

Chinese judges are also infamous for their lack of skill and experience, their unwillingness to exert discretion when adjudicating cases (partly due to the civil law tradition), and the problem of corruption. As we know, however, judges dealing with derivative suits may need more technical skills and experience, along with being fair, because of the difficulty of balancing the interests of the different parties in derivative suits, a situation which results in judges being granted more discretion. Due to this need for discretion, Chinese judges may simply not be competent to hear derivative actions or not be trusted by the parties.

5.2.2.3.2 Attitudes towards derivative actions

An interesting issue is whether Chinese tradition with its cultural distaste for litigation will have an effect on the application of derivative actions. This may be viewed from different aspects.

Legislature and court attitudes towards derivative actions

Chinese courts traditionally take a cautious attitude towards suits. Two examples may illustrate this approach. First, as mentioned, there is a procedure of docketing for deciding whether a case should be heard by the courts. Therefore, courts often will end up not solving all civil disputes. Second, the courts always keep encouraging settlement or mediation throughout the course of the hearing. A case in point: many actions with regard to false statements are settled or mediated rather than decided by the courts.[127]

126 Article 22 *et seq* of the Chinese Civil Procedural Law.

127 See Pistor & Xu (2004), p33; Xuan (2003), pp. 114-117.

Chinese legislators and courts have also been afraid of the threat of a flood of corporate litigation. The restrictions on hearing securities suits are an obvious example. Whether this attitude will affect the application of derivative actions in listed companies is still unknown.

Judicial practice and the acknowledgment of derivative actions by Company Law 2006 show that Chinese legislators and courts already recognize the importance of derivative actions. However, the legislators' approach is not as clear as it seems due to the vagueness of article 152.[128] This vagueness also grants the courts great leeway in interpreting the rules according to their own approach. Nevertheless, the history of the courts' judicial practice shows that it might be too optimistic to draw the conclusion that in practice courts will encourage derivative actions, especially derivative actions involving listed companies.

The plaintiff shareholders' attitude towards derivative actions

The plaintiff shareholders' attitude towards derivative actions will also affect the function of derivative actions. If shareholders are not willing to file derivative actions, derivative actions will then be paper tigers and cannot play their proper role.

Are minority shareholders also affected by the Chinese tradition of cultural distaste for litigation? A study of Japan, a neighbor of China, which shares with China the same cultural distaste for litigation, may illustrate the issue to a certain extent. After comparing American law and Japanese law on derivative actions and studying the development of Japanese law, Mark D. West comes to the conclusion that 'although culture may play some role in explaining actor behavior, decisions on whether to bring derivative actions are primarily determined not by culture, but by economics'.[129] West's conclusion is more than reasonable if we consider that unlike an action brought in a divorce, a personal injury case or other issues concerning social relationships, a derivative action, especially with regard to listed companies, is filed by investors whose purpose is solely to gain access to profits. Economics should be their first, if not their only, concern. In addition, our comparative study shows that factors such as the cost of litigation and the free-ride problem have an affect on the shareholders' incentive to file derivative actions as well. So these factors, in turn, will affect shareholders of Chinese companies just as much.

However, we should not ignore the influence of the Chinese legal environment on shareholder incentive to file derivative actions. The relatively poor legal environment in China, such as the dependence and poor quality of judges, the unpredictability of the law, along with the difficulty of enforcing judgments, may

128 For a detailed discussion of article 152 of Company Law 2006, please refer to Section 5.4.
129 West (1994), p. 1441. By culture he means the culture of distaste for litigation; see pp.1439-1444.

discourage shareholders, including foreign shareholders, from filing derivative actions. In fact, the current Chinese distaste for litigation may not be based on the traditional psychological position that litigation is shameful, but rather might well be based on the practical consideration of whether litigation will obtain justice for them or not.

5.2.2.4 Conclusion

In conclusion, whether derivative actions will play a more important role after the advent of Company Law 2006 is still difficult to predict. Currently, while there are factors which may still impede the application of derivative actions, derivative actions may still be seen as an important remedy that minority shareholders can use to seek relief.

However, there is no doubt that derivative action will play a more important role in limited liability companies than they will in stock companies in China. At least four factors can account for this. First, Chinese courts may take a more cautious attitude towards derivative actions with regard to listed companies due to the complexity and public effect of such cases. Second, as will be seen in Section 5.4, shareholders in limited liability companies face a lower threshold for filing derivative actions than do those in stock companies. Third, minority shareholders in Chinese limited liability companies have no other legal remedies against majority shareholder oppression, such as the unfair prejudice remedy under English law or the fiduciary duty owed by majority shareholders to them under American law and German law. The exit right for minority shareholders in limited liability companies awarded by article 75 does not cover most situations of oppression by majority shareholders. Therefore, they can only seek remedies based on derivative actions. Fourth, as is well known, there may be fewer under-incentive problems for minority shareholders in limited liability companies than there are for those in listed companies.

It is difficult to anticipate, at least currently, whether derivative actions will mainly be applied to the conflict between majority and minority shareholders, or the conflict between shareholders and directors, or both. This difficulty mainly arises from the vagueness of article 152, as well as the vagueness of the substantive law on the duties of shareholders and directors. I will come back to the issue in Section 5.4.1.1 when we discuss article 152 in detail.

5.3 The proper plaintiff principle: the distinction between derivative action and direct action

As mentioned, the only civil remedy provided in Company Law 1994 was article 111, which was generally regarded as providing a shareholder with the right to claim for injunctions only where his legal rights and/or interests were infringed

upon. This situation of lack of civil remedies has been changed in Company Law 2006. The new company law, in several articles, stipulates that shareholders can directly or derivatively file actions against the misconduct of controlling shareholders, directors (including supervisors) or senior officers. Therefore, the distinction between direct and derivative actions will also be an important issue under the new company law.

5.3.1 Claims to set aside defective resolutions of a shareholders' meeting or of the board of directors

Article 111 of Company Law 1994 was superseded by article 22 of Company Law 2006, which reads as follows:

> A resolution of the shareholders' meeting, shareholders' general meeting or board of directors of a company that violates laws or administrative regulations shall be invalid.
> If the procedure for convening or the method of voting at a shareholders' meeting, shareholders' general meeting or meeting of the board of directors violates laws, administrative regulations or the company's articles of association, or if the substance of a resolution breaches the company's articles of association, a shareholder may file a petition with a people's court to revoke the same within 60 days of the date the resolution was adopted.
> If a shareholder institutes a lawsuit in accordance with the preceding paragraph, the people's court may, at the request of the company, require that the shareholder provide commensurate security.
> ...

Therefore, according to article 22, an individual shareholder can bring an action to nullify and withdraw a void or voidable resolution of the shareholders' meeting or of the board of directors, no matter whether the shareholder's rights and/or interests were injured or not. In such cases, the distinction between direct or derivative action is no longer necessary. The shareholder can be regarded as having a statutory right to challenge defective resolutions of corporate bodies. In addition, in order to avoid unnecessary interference with corporate management by providing a shareholder with such a right, Company Law 2006 also sets several limitations on this right, such as the deadline for exercising this right and the requirement that the plaintiff shareholder post security at the company's request.

However, article 22 only grants an individual shareholder the right to bring suits in order to nullify defective resolutions. If the defective resolution has caused damage to the company or the individual shareholder, the shareholder may not claim for damages under article 22. Instead, he must rely on other articles in the law. In addition, before he claims for damages, he must first decide whether he should bring a direct or derivative action, which I will discuss in the following sections.

5.3.2 *Claims for damages arising from director (including any supervisors) and senior officer misconduct*

An important advance made in Company Law 2006 is that it explicitly states that directors, supervisors or senior officers may be held liable to the company or its shareholders if they have breached their duty. For example, articles 21 and 150 stipulate that directors, supervisors and senior officers may be held liable for compensation to the company if they breach their duty and cause losses to the company. According to article 152, minority shareholders may bring a derivative action against such infringement with certain restrictions.[130]

On the other hand, article 153 grants an individual shareholder the right to bring direct actions. It reads as follows:

> If a director, supervisor or senior officer violates laws, administrative regulations or the company's articles of association, thereby harming the interests of a shareholder, this shareholder may institute legal proceedings in a people's court in respect thereof.

Nevertheless, article 153 is not clear enough to apply in practice. Several questions may arise with regard to the individual shareholder's right to bring direct actions. First of all, it is not clear what the shareholder's interests are. Where the company was injured and shareholders suffered indirect (reflective) losses due to the reduced value of the company, can we say the shareholders' interests were also infringed upon and therefore can apply article 153? The comparative study and the intention of Company Law 2006 to make a distinction between direct and derivative action may show that the shareholders' reflective losses should not be included in a definition of 'the interests of shareholders.' Therefore, an individual shareholder should not be allowed to apply article 153 in order to bring a direct action for his reflective losses.

The second question is who should be the defendant where an individual shareholder brings a direct action according to article 153, is it the company or the wrongdoing director or senior officer? The wording of article 153 may well imply that the defendant should be the wrongdoing director or senior officer. However, sometimes when the director or senior officer is guilty of misconduct, he was acting on behalf of the company; it is the company then which would owe the duty to the individual shareholder. Therefore, the company rather than the wrongdoing director or senior officer should be the defendant. Of course, the company may, in turn, seek remedies against the wrongdoing director or senior officer for the losses. As a result, when deciding who should be the defendant, we should identify who owes the duty to the individual shareholders. There may be several possibilities: (1) The company may be the defendant. For example, where

130 For the scope of the shareholders' right to derivative actions, please see Section 5.4.1.

a decision made by the board of directors has infringed upon the shareholder's right to participate in the shareholders' meeting or the right to a dividend decided on, the shareholder may bring a direct action for damages against the company, since the decision was made in the name of the company and the duty not to infringe on such rights is owed by the company.[131] (2) The wrongdoing director or senior officer may be the defendant. Although Company Law 2006 does not mention the duty of directors and senior officers towards individual shareholders, such a duty may be laid down in other laws, such as securities law, contract law or law of torts. A common example, which we have already seen in the comparative study, is that a director may breach his duty to an individual shareholder where he sold shares to the shareholder with the knowledge that the share price would fall afterwards. (3) Both the company and the wrongdoing director or senior officer may be the defendants. For example, according to article 69 of Securities Law 2006, where there was misrepresentation and the shareholders suffered losses, the company will be held liable to the shareholders and the wrongdoing directors, senior officers and so on will be held liable jointly.

The third issue is that article 153 stipulates that a shareholder can only bring a direct action where a director or senior officer infringed his interests; therefore literally it does not include a supervisor's infringement. However, theoretically a shareholder should also have the right to bring an action where a supervisor has violated the law and the articles of associations, and has infringed upon his interests.

Since Company Law 2006 acknowledges both the shareholders' direct actions and derivative actions against directors, supervisors and senior officers' misconduct, the problem then lies in how to distinguish the actions. As we saw from the comparative study, two standards may be applied to make the distinction: the 'rights' standard and the 'injury' standard. Company Law 2006 is vague as to the standard it sets since it adopts both the words 'injury' and 'interest.' Nevertheless, where the Chinese situation is concerned, the 'injury' standard may be more suitable since it may be difficult to identify the 'interest' of the plaintiff or the 'duty' of the defendant under Chinese law. Although as in Western countries, Company Law 2006 also recognizes that directors, supervisors and senior officers generally have a duty to the company rather than to shareholders individually[132], it is unclear what that duty is and what remedies the victim will qualify for if the duty has been breached. It is also unclear under what circumstances the company, directors, supervisors or senior officers will owe this duty directly to the shareholders individually. In addition, Chinese courts may not be competent to distinguish between the duty owed to the company and the duty to the shareholders individually.

131 But as mentioned, if he only claims to nullify the resolution, the shareholder can bring an action according to article 22.

132 See articles 21, 148-149 of the Company Law 2006.

5.3.3 *Claims for damages arising from shareholder misconduct*

It may be more difficult under Company Law 2006 to make a distinction between shareholders' direct action and derivative action against the misconduct of other shareholders. Before we discuss this issue, we should first have a look at whether there is a possibility for minority shareholders to bring derivative actions against other shareholders. The answer is affirmative according to article 152 of Company Law 2006.[133]

A shareholder's duty and liability to the company and to other shareholders is briefly stated in article 20 of Company Law 2006.[134] This article is the basic one that governs the shareholder's duty and liability to the company, to other shareholders as well as to creditors. In addition, article 21 also stipulates that the controlling shareholder of the company shall not, by taking advantage of their affiliate relationship, damage the interests of the company; otherwise, he will be held liable for compensation to the company should the company suffer any loss. There is no further regulation in Company Law 2006 with regard to the duty owed by a shareholder to the company, nor as to the duty to other shareholders.

Articles 20 and 21 impose duties owed by a shareholder both to the company and to other shareholders. However, it is not clear what the content of the duties is or which conduct, in other words, amounts to 'abuse' of shareholder rights. It is not clear either whether the duty is owed to the company or the individual shareholders in specific cases. Therefore, it is not appropriate to classify the nature of the action by identifying whose rights have been infringed, the company's or the individual shareholder's. On the contrary, we have to classify the action by examining who has suffered the losses. This, however, may put the minority shareholders in a poor position if the majority shareholders oppress them by infringing on the company's interests, such as by appropriating the corporate assets. In such cases, since the minority shareholders suffered no direct losses and since Company Law 2006 does not grant them the exit remedy, they can only file a derivative action, and therefore the duty owed to them by the majority shareholders is only a paper tiger.

5.4 Striking a balance between corporate efficiency and protection for the company and the minority shareholders

Chinese legislators and courts also face the problem of how to strike a fair balance between corporate efficiency and protection for the company and minority shareholders. Company Law 2006, as well as the courts that heard the derivative suits before Company Law 2006, has paid attention to this issue. However,

133 As to the scope of and prerequisites for such actions, please refer to Sections 5.4.1 and 5.4.2.

134 For the regulation of article 20, please refer to Section 5.1.1.4.3.1.

Chinese legislators and courts have mainly focused on procedural limitations rather than the substantive limitations on derivative actions.

Our discussion on how Chinese law strikes a balance mainly focuses on Company Law 2006. Article 152 of Company Law 2006 grants minority shareholders the right to initiate derivative actions by providing that:

> If a director or senior officer has committed a violation as specified in article 150 hereof, the shareholders of a limited liability company or (a) shareholder(s) of a company limited by shares who alone or jointly has/have held at least 1% of the company's shares for at least 180 days in succession may make a request in writing to the supervisory board, or in the case of a limited liability company that has not established a supervisory board, the supervisor(s) that it/he/she/they institute legal proceedings in a people's court in respect thereof. If a supervisor has committed a violation as specified in article 150 hereof, the aforementioned shareholders may make a request in writing to the board of directors, or in the case of a limited liability company that has not established a board of directors, the executive director that it/he/she institute legal proceedings in a people's court in respect thereof.
> If the supervisory board, supervisor(s) of a limited liability company that has not established a supervisory board, board of directors or executive director refuses to institute legal proceedings after receipt of the written request from the shareholders mentioned in the preceding paragraph, fail(s) to institute legal proceedings within 30 days of the date of receipt of the request or, under urgent circumstances where failure to promptly institute legal proceedings could cause possibly irreparable harm to the company's interests, the shareholders mentioned in the preceding paragraph shall have the right, in the interests of the company, to directly institute proceedings in a people's court in their own name.
> If another person[135] infringes upon the lawful rights and interests of a company, causing the company to incur a loss, the shareholders mentioned in the first paragraph hereof may institute legal proceedings in a people's court in accordance with the provisions of the two preceding paragraphs.

Nevertheless, since the statute itself is vague in many respects, the judicial attitude also plays an important role. In fact, Xi Xiaoming, the associate chief justice of the SPC, said that the SPC would in the future publish judicial interpretations on the application of derivative actions and other regulations in Company Law 2006.[136]

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135 The English version translated by China Law & Practice uses the term 'a third party' instead of 'another person.' However, when compared to the original Chinese version, I think the translation 'another person' is more accurate since 'a third party' may be thought to exclude the controlling shareholder.

136 Zhou (2005).

5.4.1 Substantive limitations on the scope of derivative actions

5.4.1.1 Whose misconduct may be lead to a derivative action

According to article 152, derivative action is mainly intended to seek remedies against the misconduct of directors, supervisors and/or senior officers. However, what other infringement might be a cause of derivative action is rather vague under article 152.

The vagueness is caused by the last paragraph of article 152, which states that:

> If another person infringes upon the lawful rights and interests of a company, causing the company to incur a loss, the shareholders mentioned in the first paragraph hereof may institute legal proceedings in a people's court in accordance with the provisions of the two preceding paragraphs.

The ambiguity of the paragraph is mainly due to the wording 'in accordance with the provisions of the two preceding paragraphs.' In fact, there may be two ways to explain the wording and the paragraph. The first one is that 'in accordance with the provisions of the two preceding paragraphs' means that the conditions in the two preceding paragraphs must also be met. Therefore, in order to sue against infringement by another person, misconduct on the part of directors, supervisors and/or senior officers must also exist. Or in other words, the cause of the action should be the misconduct of the directors, supervisors and/or senior officers. Another explanation is that 'in accordance with the provisions of the two preceding paragraphs' only means following the procedures stipulated in the two preceding paragraphs. Therefore, the shareholders who meet the requirements stipulated in the two preceding paragraphs can bring a derivative action against infringement by another person, no matter whether the directors, supervisors and/or senior officers have committed any misconduct or not.

However, because the term 'another person' in the paragraph may be broadly interpreted to include the controlling shareholder of the company, as well as a third party such as a business person who simply signed a contract with the company, and because the regulation regarding the effect of the demand requirement is also problematic, which I will come back to later, neither explanation may be appropriate. The first explanation may be too narrow since it excludes the controlling shareholders' misconduct from being the cause of derivative action. As we know, however, because the abuse of power by the controlling shareholders is a major agency problem in both limited liability companies and stock companies in China, and because the duty of directors, supervisors and senior officers is not clear and is difficult to enforce, such an explanation may make it difficult to discipline the controlling shareholders and so protect the company and minority shareholders against any misconduct by the controlling shareholders. In fact, the judicial opinions of some local high courts on derivative actions have already included the controlling shareholders' misconduct, as well as that of the directors, supervisors and senior officers, as

being possible causes of derivative action.[137] On the other hand, however, the second explanation may be too broad. If any person's infringement on the company can be the cause of derivative action, it would be very easy for the minority shareholders to unjustly interfere with corporate management. As a result, the last paragraph of article 152 should be explained to include the controlling shareholders' misconduct, rather than a third party's misconduct, as being the causes of derivative action.

5.4.1.2 Nature of the defendant's misconduct that may lead to a derivative action

Restriction of article 150

The comparative study shows that an important mechanism which prevents the unjust interference with corporate management by derivative actions and provides necessary protection for directors, supervisors and senior officers is to restrict the nature of the defendant's misconduct which may lead to derivative actions; or in other words, derivative actions may not be applied against certain misconduct. Does Company Law 2006 also restrict the misconduct of directors, supervisors and senior officers which may lead to derivative actions? The answer may be yes. However, the restriction may not be reasonable and might not serve the purpose of protecting corporate management. In addition, the restriction may also have the effect that the company and minority shareholders cannot be protected in certain situations.

The restriction is mainly embodied in articles 150 and 152. As we have already seen, article 152 grants minority shareholders the right to bring derivative actions against directors, supervisors and/or senior officers where the latter fall under the conditions of article 150.[138] Article 150, which stipulates the liability of

137 See, for example, Beijing High People's Court, Beijingshi Gaojirenminfayuan Guanyu Shenli Gongsi Jiufen Anjian Ruogan Wenti de Zhidao Yijian (Shixing) [The Guiding Opinions of Beijing High People's Court on Several Issues on Adjudicating Corporate Dispute Cases (Trial Implementation), issued in February, 2004, article 1(8); No. 2 Civil Division of Shanghai High People's Court, Guanyu Shenli Sheji Gongsi Susong Anjian Ruogan Wenti de Chuli Yijian (yi) [The Opinions on Adjudicating Cases Regarding Corporate Litigations (No. 1)], issued in June, 2003, article 5(2); The High People's Court of Jiangsu Province, Jiangsusheng Gaojirenminfayuan Guanyu Shenli Shiyong Gongsifa Anjian Ruogan Wenti de Yijian (Shixing) [The Opinions of the High People's Court of Jiangsu Province on Several Issues on Adjudicating Cases Applying Company Law (Trial Implementation), issued in June, 2003, article 17.

138 Article 21 also stipulates that directors, supervisors and senior officers may be held liable for compensation to the company if they caused losses to the company by taking advantage of their affiliate relationship. Although article 152 literally only grants shareholders the right to derivative actions where there are circumstances as stipulated in article 150, the shareholders' right to derivative actions should also include the circumstances of article 21.

compensation to the company by directors, supervisors and/or senior officers, states that:

> If a director, supervisor or senior officer violates laws, administrative regulations or the company's articles of association *in the course of performing his or her company duties*, thereby causing the company to incur a loss, he or she shall be liable for damages. (Emphasis added.)

The wording of the two articles naturally brings up the question of whether the director, supervisor or senior officer should be held liable if he violated the law or the articles of association and caused losses to the company while acting under other circumstances rather than in the course of performing his company duties. If the answer is positive, then can minority shareholders bring a derivative action against him?

If we interpret articles 150 and 152 literally, we can draw the conclusion that a derivative action should not be allowed against directors, supervisors and/or senior officers if they caused losses to the company while not in the course of performing company duties. However, this restriction on the shareholders' right to derivative actions may not be reasonable. Since directors, supervisors and/or senior officers may commit misconduct in other circumstances, and the company is prevented from suing them in such cases as well, then derivative actions are still necessary in order to make them liable and to protect the interests of the company as well as those of minority shareholders. Derivative actions are needed because of wrongdoers' conflict of interest in litigation; under what circumstances they committed the wrong is not relevant.

Lack of the principle of non-judicial interference in corporate management

Our comparative study shows that Western countries widely acknowledge the principle of non-judicial interference in corporate management. The justifications for the principle have been listed in Section 1.6.2, so I will not repeat them again. Nevertheless, we should bear in mind that this principle is very important for keeping a fair balance between corporate efficiency and protection for companies and minority shareholders; therefore it must be taken into account when applying the mechanism of derivative action.

Unfortunately we cannot find such a principle in Chinese Company Law 2006, and therefore the law may well not provide effective protection for the efficiency of corporate management as well as for directors, supervisors and senior officers. As we know, Company Law 2006 does explicitly state that directors, supervisors and senior officers owe a duty of loyalty and a duty of diligence (the duty of care) to the company.[139] However, it does not restrict director misconduct that may lead

139 Article 148 of Company Law 2006.

to derivative actions to certain misconduct such as fraud, dishonesty or gross violations of the law or the articles, nor does it include the business judgment rule. As a result, minority shareholders may bring derivative actions against directors for mere breach of duty of care under Company Law 2006. This certainly would prove fatal to directors as well as corporate business.

Chinese courts also hardly have any experience in dealing with a director's breach of duties, especially breaches of the duty of care. Company Law 1994 did not explicitly impose the duty of care on directors; therefore, as far as we know, there has been no action against the director's breach of duty of care except under article 118 of Company Law 1994, which actually imposed a strict liability on directors (that is, no proof of the breach of duties is needed).[140] Therefore, Chinese courts have had no opportunity to show their attitude toward issues such as what the duty of care is, under what circumstances a director might breach his duty of care, and whether the court should judge the director's business decisions.

The danger under current Chinese company law is that a director or senior officer may be held liable for simply making careless or 'bad' business decisions, which can only be judged in hindsight. This shows that it is necessary to introduce the principle of non-judicial interference in corporate management into Chinese company law. However, as we now know, there are at least two mechanisms for implementing this principle. One is to provide *ex ante* restrictions by law that only certain kinds of misconduct, excluding the mere breach of duty of care, may give rise to derivative actions. The traditional English common law derivative action and the current German law (section 148 of the AktG (UMAG)) take this approach. The American business judgment rule, which provides a safe harbor for directors, plays a similar role in practice: although the American law on derivative actions does not explicitly restrict the application of derivative actions to certain misconduct *ex ante*, the prevailing approach of the business judgment rule requires that the plaintiff bear the burden to prove certain misconduct of directors in order to rebut the presumption that the defendant director is deemed to have fulfilled his duty; therefore, the plaintiff needs to prove something more than the director's mere breach of duty in order to hold the director liable. The other mechanism is that although there is no *ex ante* restriction, the court will exercise its discretion not to interfere with business judgment when hearing cases. This approach is taken by, for example, the British Companies Bill. We also know that each mechanism has its own advantages and disadvantages. For example, the first mechanism has the advantage that the law is more stable and anticipatable; however, it also has the disadvantage that the plaintiff has to bear the burden of proof; that is not easy, especially considering his poor position concerning acquiring information; besides, how to make the *ex ante* restrictions is also problematic: a too narrow restriction will not provide sufficient protection for the

140 I will discuss article 118 of Company Law 1994, and its successor in Company Law 2006, in the next section.

company and minority shareholders, while too wide a restriction will unjustly interfere with corporate management. On the other hand, the second mechanism may not have the same problems as the first mechanism; nevertheless, it needs the court's wide discretion to strike a fair balance, which the courts in civil law countries may not be used to.

As a result, China may face the difficult issue of which mechanism should be introduced in order to protect the efficiency of corporate management. Due to the current situation of Chinese courts, the second mechanism, which totally depends on the court's discretion to protect corporate efficiency, may not be appropriate for China. An *ex ante* restriction in the Company Law may not be appropriate either since it would need an amendment to the current company law, which would involve the legislature. Therefore, the American style of business judgment rule may be more suitable for China. In addition, the introduction of the business judgment rule would also have the advantage that it would not only provide protection for directors and senior officers in derivative actions, but also in actions brought against them by the company as well. Of course, in order to avoid disorder in judicial practice, the Supreme People's Court should publish judicial interpretations of the application of this rule. Actually, the necessity of introducing the business judgment rule has also been recognized by some scholars and practitioners. For example, Li Guoguang, a former associate chief justice of the Supreme People's Court and currently a commissioner on the Law Committee of the People's Congress, and Wang Chuang, a judge of the No. 2 Civil Division of the Supreme People's Court, have both suggested that the court should introduce the business judgment rule when deciding a directors' liability.[141]

A strict liability for directors in stock companies

To make matters worse, Chinese company law may actually provide less protection for directors in stock companies. The directors may be held liable even if they did not breach their duty. The third paragraph of article 113 of Company Law 2006, which applies to stock companies only[142], states that:

> Directors shall bear liability for the resolutions of the board of directors. If a resolution of the board of directors violates laws, administrative regulations, the company's articles of association or the resolutions of the shareholders' general meeting, causing the company to incur serious losses, the directors who took part in such a resolution shall be liable to the company for damages. However, if a director is proved to have expressed his or her opposition to such a resolution when it was put to the vote, and such opposition has been recorded in the minutes of the meeting, such a director may be released from such liability.

141 See, for example, Li G. & Wang (2006).

142 There is no relevant article with regard to directors in limited liability companies.

Article 113 imposes director liabilities for defective resolutions of the board of directors. However, according to the article, director liabilities do not depend on whether they have fulfilled their duties, but upon the legality of the board's resolution. A director can only be relieved of the liability if he did not participate in the wrongful resolution or expressly objected to that resolution and had the objection recorded. Since a director's performance of company duties obviously includes involvement in resolutions of the board of directors, the director liabilities under article 113 should be covered by article 150. Therefore, shareholders may be able to bring derivative actions against these directors according to article 113 as well.

This regulation in article 113, which follows the approach of article 118 of Company law 1994, is too rigid and puts too much of a burden on directors. According to this article, directors may be held liable even if they did not breach their fiduciary duty. It requires that a director discover the illegality of the board's decision *ex ante*, no matter whether it is possible for him to discover it or not. This requirement is especially unkind to independent directors who are not supposed to be participating in the company's daily operations. Although it may deter director misconduct, this strict liability, in the long run, will discourage appropriate people from becoming directors and thus will negatively affect corporate management as well as investors' interests. In fact, the approach taken by article 113 also runs contrary to international trends. In Western countries, it is generally agreed that a director can be free of liability if he has performed his duty.

Article 113 may have another defect if literally interpreted. If a director breached his duty of diligence and did not attend the meeting, he may not be held liable for the defective resolution of the board under this article since he did not participate in making the resolution. However, this freedom from liability should not be justifiable because the director may well have breached his duty by not attending the meeting.

5.4.2 *Procedural restrictions*

5.4.2.1 *The procedure of docketing (li'an)*

As mentioned in Section 5.1.1.4.2.4, a potential plaintiff must first file the case with the li'an division of a people's court. The li'an division has the power to examine whether the case has satisfied the four conditions required by article 108 of the Civil Procedure Law and then to decide whether to accept the case or not. This procedure applies to all civil cases, including derivative actions.

Several issues around the application of this docketing (li'an) procedure to derivative actions may require special attention. To begin with, as mentioned, the first requirement that a potential plaintiff must satisfy is that 'the plaintiff must be a citizen, legal person or any other organization that has a direct interest in the

case'.[143] Where the company has suffered losses, the traditional view is that it is the company, rather than shareholders individually, which has the direct interest in the case. Since the Chinese Civil Procedure Law has not been amended as yet, the li'an division should not be applying this requirement to derivative actions.

Second, the li'an division may exercise more discretion when examining derivative actions. Generally the li'an division will only examine the case procedurally rather than substantively: as long as the four requirements have been satisfied, the case must be accepted.[144] Nevertheless, the requirements that 'there must be specific claim(s), fact(s), and cause(s) for the suit' and that 'the suit must be within the scope of acceptance for civil actions by the people's court'[145] may leave room for the court's discretion. Since the derivative action is a new type of action and runs the risk of being abused, it is possible that Chinese courts might, in turn, apply more discretion when examining it. Of course, this is only our expectation and it is still to be seen whether Chinese courts will actually apply more discretion and, if they do, on what basis.

Third, it is uncertain whether 'the Circular on Questions Relating to the Acceptance of Cases Involving Civil Disputes Arising from Infringement of Rights Due to Fraudulent Statements on the Securities Markets' (Circular 2003) of the Supreme People's Court[146], which limits the scope of actions in the securities markets, will also apply to derivative actions. If it does, minority shareholders may only bring derivative actions against those cases in which there have already been a relevant authority's administrative penalty decisions or the court's criminal judgments.

In fact, the procedure of docketing (li'an) may serve as a judicial screen and therefore prevent abusive derivative actions, especially those which cannot satisfy the requirements of the Civil Procedure Law. However, to what extent the docketing procedure will prevent abusive (or sometimes perhaps meritous) deriative actions is still unknown. This may depend on the standards the li'an division might apply when examining the derivative actions before it. For example, will the division consider whether article 152 has been satisfied? Or will the division consider the best interests of the company? Further judicial interpretations on the issues are actually expected.

5.4.2.2 The standing requirements

Company Law 2006 treats shareholders in limited liability companies and those in stock companies differently as far as their standing to initiate derivative actions is concerned. According to article 152 (1), any individual shareholder in limited

143 Article 108 (1) of the Chinese Civil Procedure Law.

144 Articles 111 and 112 of the Chinese Civil Procedure Law.

145 Article 108 (3) and (4) of the Chinese Civil Procedure Law.

146 See Section 5.1.1.4.2.4.

liability companies can initiate a derivative action; however, shareholders in stock companies must hold more than one percent of corporate shares individually or aggregately for 180 consecutive days in order to initiate a derivative action.

It is rational that there should be no minimum capital threshold for shareholders in limited liability companies when they come to file derivative actions because the abusive use of derivative actions in limited liability companies is rather uncommon.[147] This easy access to derivative actions for shareholders in limited liability companies is also important for them because they still have difficulty seeking other relief.

However, the threshold with regard to stock companies may be too strict, especially considering Chinese special situations. First, the requirement to hold more than one percent of shares does not take into account the situation of large companies. In large companies, even one percent of shares involves a huge amount of capital. Therefore, the German approach to the threshold, which requires that shareholders hold one percent of the share capital or the *pro rata* amount of EUR 100,000, is more reasonable. Second, the one-percent threshold may still be impractical considering the nature of the shareholding structure in Chinese listed companies. As mentioned, shares in listed companies are divided into non-tradable and tradable shares. The non-tradable shares are generally owned by a very few shareholders, normally the state or legal persons, while the shareholding of tradable shares is widely scattered. In addition, the percentage of tradable shares in the whole market is relatively low, even now, despite the fact that the Equity Division Reform has been in effect for some time.[148] As a result, for tradable shareholders the one percent threshold is too high. Although theoretically minority shareholders can consolidate to meet the one percent requirement, this will entail much time and expense. Third, the requirement of holding shares for 180 consecutive days may also be a real obstacle to shareholders in listed companies. Chinese securities markets are notorious for speculation and investors normally buy shares for short-term profit rather than long-term profit. Therefore, the average holding period for shares is very short. The study by Jin Xin showed that the average holding period was less than four

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147 This opinion is confirmed by Chinese judges the author has interviewed. Also see Thompson & Thomas (2004), pp. 1784-1785.

148 For example, in the Shanghai Stock Exchange there were about 470 billion shares altogether in 2004, while of those about 137 billion were tradable shares, which is only about 29 percent of the total; see SSE (2004). In March 2006, almost six months after the start of the Equity Division Reform, the percentage of tradable shares is a little bit higher, but not significantly. In March 2006, there were about 504 billion shares and about 163 billion were tradable; thus tradable shares are about 32 percent of the total; see the website of the Shanghai Stock Exchange: http://www.sse.com.cn/sseportal/ps/zhs/home.shtml, March 21, 2006.
The percentage of tradable shares is a little bit higher on the Shenzhen Stock Exchange, but it is still only about 46 percent as of March 2006. In March 2006, on the Shenzhen Stock Exchange, there were altogether about 213 billion shares; about 97.5 billion were tradable shares; the data is available at the website of Shenzhen Stock Exchange: http://www.szse.cn/main/marketdata/ Catalog_1803.aspx, March 21, 2006.

months.[149] In such a situation, the 180 consecutive-day requirement is significant. As a result, although the policy consideration under the standing requirements with regard to stock companies is to prevent the minority shareholders' abusive use of derivative actions, these requirements may significantly deter minority shareholders (as opposed to the state and legal-person shareholders) in listed companies from bringing derivative actions.

5.4.2.3 The demand requirement

On whom the demand will be made

According to article 152(2), qualified minority shareholders may bring derivative actions in three alternative situations. The first situation is where the relevant body of the company refuses to bring an action after the minority shareholders have submitted a written demand to it. The second one is where the body has failed to bring an action within thirty days of receipt of the written demand. And the third one arises under urgent circumstances where the company's interests will suffer irreparable damage if no lawsuit is brought immediately. Except in the last situation, the minority shareholders need to make a written demand before they can file a derivative action. In order to avoid conflicts of interest when the corporate bodies make a litigation decision, article 152 requires that the demand should be made upon the supervisory board, or the supervisors of a limited liability company without a supervisory board, in those cases where an action is taken against the managing directors or senior officers. Where the action is against the supervisors, however, the demand should be made on the board of directors or upon the executive director of a limited liability company without a board of directors. Still, it is unknown on whom the demand should be made when it is the directors, senior officers and supervisors who are being sued. In addition, there may also be another problem: if article 152(3) is interpreted as granting qualified minority shareholders the right to bring a derivative action against the wrongdoing controlling shareholder, in cases where at the same time no director, senior officer or supervisor has committed a wrong, on whom then should the minority shareholder make the demand? The difficulty lies in the fact that normally both the board of directors and the supervisory board are under the control of the controlling shareholders and therefore are unlikely to make a fair litigation decision.

The effect of the demand

Article 152 may be problematic as to the effect of the demand if literally interpreted. The first problem is whether a just and reasonable refusal of the demand should have a binding effect. As we know, minority shareholders may bring a

149 Jin (2005), pp. 143-144.

derivative action as long as they have made a written demand on the relevant body and the demand has been refused. However, the relevant body's decision not to sue may be just and reasonable since the body which made the decision has, at least theoretically, no conflict of interest as to the decision. Although it is a notorious fact in China that supervisors are almost never truly independent from directors, this is still an issue which should end up being decided on a case-by-case basis. If the relevant body's negative litigation decision (refusal of the demand) is just and reasonable, it would be unreasonable if such a decision could not prevent minority shareholders from filing derivative actions. After all, one rationale for the demand requirement is that the intra-corporate bodies on which the demand has been made are *prima facie* regarded as being more appropriate for making litigation decisions than minority shareholders are.

Nevertheless, if the relevant body's litigation decision is to be deferred to, several issues will then arise: (1) who should have the power to decide whether the corporate body's litigation decision should be binding or whether the derivative action should be allowed? In fact, it is generally agreed that whether the corporate body's litigation decision is just and reasonable should be decided case by case, and therefore it is the court which should be the appropriate body for deciding the effect of the corporate body's litigation decision. In fact, it is difficult and inappropriate to create an *ex ante* standard in the statute. This is also the approach taken by the countries we chose to study in this book. (2) Which standards should be applied when deciding the effect of the body's litigation decision? As we know, the countries we studied have also taken different approaches to this issue. Considering the situation of Chinese courts, the Supreme People's Court of China should issue guidelines that list the several factors the court should consider when deciding such cases.

The second issue as to the effect of the demand is as follows: if the relevant body agrees to bring a corporate action in order to block the minority's derivative action but fails to pursue the corporate action diligently and therefore deliberately loses the case, the interests of the company and minority shareholders still may end up not being protected. In such cases, it is better to allow the minority's derivative actions. As a result, even if the relevant body decides to bring a corporate action upon the demand of the minority shareholders, it is not necessary that this body be the most appropriate one to represent the company.

Thirdly, the regulation that qualified minority shareholders can bring a derivative action if the body fails to bring an action within thirty days of receipt of the written demand is also a problematic one. As we know, some cases may be complicated and it will take more time for the body to investigate and decide whether it is in the best interests of the company to bring an action. A cursory decision may not be good for the company. Of course, since the minority shareholders can bring a derivative action as long as the body refuses to sue, this thirty-day requirement is actually intended to prevent the body from suspending the minority's right to derivative actions by doing nothing. Nevertheless, a

negative result of the thirty-day requirement is that the body may make a cursory decision to sue.

In conclusion, the regulation on the demand requirement in article 152 is positive in the sense that it avoids multiplicity of suits, especially when the corporate body also decides to sue. However, if it is interpreted literally, article 152 may not provide enough protection for the company and minority shareholders. It also has the fatal defect that it may not protect corporate efficiency since it may have no effect on deterring qualified shareholders from bringing derivative actions if they fulfill the procedural requirement to make a written demand, no matter whether the derivative action is necessary or not. The only burden on the shareholders is that they have to make a written demand and then wait for thirty days. Therefore, the demand requirement in article 152 cannot effectively prevent shareholders' abusive use of derivative actions and their unjust interference in corporate management. Interference in corporate management would be more possible if article 152 was broadly interpreted to include the misconduct of 'other persons' as a possible cause of derivative action.

5.4.3 The independent body's view

Chinese legislators have already considered the issue of conflict of interest when deciding who should make the corporate litigation decision. Since Chinese company law also adopts the two-tier system, it takes the same approach as German law does. Where the claim is against directors and/senior officers, the demand should be made to the supervisory board, or to the supervisors where there is no supervisory board. On the other hand, where the claim is against the supervisors, the demand should be made to the board of directors, or to the managing director where there is no board of directors. Under company law, the two boards are supposed to be independent of each other.

However, as mentioned in Section 5.1.1.4.3.1, the problem in China is that the supervisory board or the supervisors may not be sufficiently independent in practice. Therefore, it is doubtful whether the supervisory board or the supervisors are the appropriate ones to be making any corporate litigation decision against the directors and/or senior officers.

5.4.4 Incentives for the plaintiff to pursue derivative actions

5.4.4.1 Litigation costs

As mentioned in Section 5.2, shareholders of Chinese companies may be more unwilling to initiate derivative actions than those of Western companies for several reasons. One of the most important of these reasons is the financial burden laid on the plaintiff shareholders.

Shareholders in China who plan to file a derivative action may, as a result, find themselves burdened with huge financial costs. The costs are composed of at

least two parts: the court's fees and the attorneys' fees. In addition, certain under-the-table fees may also have to be paid.

The court fees[150]

The court fees include the filing fees [anjian shouli fei] paid to the court before the suit can proceed and other expenses incurred during the hearing of the case, such as fees for investigation and for preservation of assets.

According to article 107 of the Chinese Civil Procedure Law and article 13 of the SPC's Measures on the People's Courts' Acceptance of Litigation Fees issued in 1989, any plaintiff who files a suit with the court must submit a certain amount of money to the court within seven days after he has received the court's notice to pay. If he does not pay, the case will be treated as withdrawn by the plaintiff and will not be continued. If the disputes are with regard to property, the filing fees are proportionate to the disputed amount (that is, a sliding system). For example, according to the SPC's Measures on the People's Courts' Acceptance of Litigation Fees (1989), the standards of the amount of filing fees with regard to proprietary suits are as follows: if the disputed amount is less than 1,000 RMB yuan, the filing fee is 50 yuan; if between 1,001 yuan and 50,000 yuan, the fee is 4 percent of the disputed amount plus 10 yuan; if between 50,001 yuan and 100,000 yuan, the fee is 3 percent of the disputed amount plus 510 yuan; if between 100,001 yuan and 100,000 yuan, the fee is 2 percent of the disputed amount plus 1510 yuan; if between 200,001 yuan and 500,000 yuan, the fee is 1.5 percent of the disputed amount plus 2510 yuan; if between 500,001 yuan and 1,000,000 yuan, the fee is 1 percent of the disputed amount plus 5010 yuan; if more than 1,000,000 yuan, the fee is 0.5 percent of the disputed amount plus 10,010 yuan.[151] If the plaintiff decides to withdraw the case, he still has to pay half of the filing fees as well as the other litigation costs already incurred.[152]

Since derivative actions belong to the category of proprietary cases, the filing fee can be very high. For example, in the *Xin Jiangnan* case (decided in Jiangsu province), the filing fee was 152,573 RMB yuan (about EUR 15,200)[153]; in the *Huafeng* case (decided in Guangdong province)[154], the filing fee was 20,743 RMB yuan (about EUR 2,000); in the *Zhongqi Qihuo* case (decided in Beijing), the filing fee was about 830,000 RMB yuan (about EUR 83,000).[155] Therefore, it

150 Many Chinese scholars have criticized the system of court fees. See, for example, Fang (2000).
151 See article 5(4) and the attachment of 'The Schedule of Simplified Calculation on the Filing Fees Regarding Proprietary Disputes' of the SPC's Measures on the People's Courts' Acceptance of Litigation Fees (1989).
152 Article 23 of the SPC's Measures on the People's Courts' Acceptance of Litigation Fees (1989).
153 SPC's Gazette, Vol. 6 of 2001 (in general Vol. 74), pp. 213-214.
154 Wang T. (2001).
155 Wang N. (2006).

is understandable that in China many plaintiffs are purported to have reduced the disputed amount in order to pay lower filing fees. For example, in the above-mentioned *Sanjiu* case, the individual shareholder of a listed company only claimed 20,000 RMB yuan (about EUR 2,000), which was much less than the real disputed amount, on behalf of the company against the defendant directors in the derivative claim.[156]

However, problems may arise if the practice of the *Sanjiu* case is widely applied. First, if the plaintiff shareholder reduces the disputed amount in order to pay lower litigation fees, the company he represents may not be adequately compensated if the judgment only refers to the claimed amount. This also gives rise to a relevant issue of whether other shareholders can bring another action based on the same cause of action but with a different disputed amount. Second, a serious deterrence to derivative suits may be circumvented if the plaintiff shareholder can claim for a smaller disputed amount. Nevertheless, article 7 of the SPC's Measures on the People's Courts' Acceptance of Litigation Fees (1989) may lead to a different conclusion. The article states that 'in proprietary cases if the claimed disputed amount is different from the real disputed amount, the filing fees should be levied according to the real disputed amount as calculated by the people's court.' In practice, courts have great discretion in deciding the disputed amount.

Attorneys' fees

Although they will vary greatly in different cases, attorneys' fees are also a serious financial burden on the plaintiff shareholders. Nevertheless, a special agreement between the plaintiff and the attorney, which is similar to the American contingency fee arrangement, may help to reduce the plaintiff's burden to a certain degree.[157]

The principle of allocation of costs

According to article 19 of the SPC's Measures on the People's Courts' Acceptance of Litigation Fees (1989), the losing party should bear the filing fees and other litigation fees allocated by the court, which normally includes the fees paid to the court but excludes the attorney's fees. Therefore, if the plaintiff shareholder loses the case, he has to pay a serious amount in litigation costs. However, even if the plaintiff shareholder wins, he still has to pay the attorney's fees and may suffer financial loss if the defendant is bankrupt or refuses to pay him back for the litigation fees. In the latter case, he has to apply to the court for the enforcement of the judgment; the filing fees for enforcement cases are also proportionate to the amount to be enforced.

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156 Xu (2003).

157 Such a special agreement exists in Chinese legal practice.

No regulations on indemnity to the plaintiff by the company

Although plaintiff shareholders in derivative actions bear the risk of a heavy financial burden for the benefit of the company, with the damages going to the company if they win the cases, there is no regulation on indemnity for the plaintiff shareholders by the company in Company Law 2006.

Nevertheless, some local courts have recognized the necessity of such indemnity and have allowed it in their judicial opinions. According to article 5 of The Opinions of Shanghai High People's Court on Adjudicating Cases Regarding Corporate Litigations (No. 1) [Shanghai High People's Court Guanyu Shenli Sheji Gongsi Susong Anjian Ruogan Wenti de Chuli Yijian (yi)] (June 2003), courts can decide that the benefiting company should pay a reasonable indemnity to the plaintiff shareholder. Article 78 of The Opinions of the High People's Court of Jiangsu Province on Several Issues on Adjudicating Cases Applying the Company Law (Trial Implementation) [Jiangsusheng Gaojirenminfayuan Guanyu Shenli Shiyong Gongsifa Anjian Ruogan Wenti de Yijian (Shixing)] (June 3, 2003) also states that in derivative actions if the court supports the plaintiff's derivative claims, reasonable litigation fees such as the attorney's fees and travel costs should be borne by the company; if the court does not support the derivative claims, the litigation costs should be paid by the plaintiff shareholder; if the court partly supports the claims, the plaintiff shareholder and the company should bear the costs *pro rata*.

Conclusion

High litigation costs and lack of indemnity rules actually work as a serious deterrence to shareholders' derivative actions. Compared to the large amount of filing fees the plaintiff shareholders have to pay in advance and the high risk of financial burden they bear, the indirect benefit they will acquire if they win the case is not attractive at all. Indeed they hardly have any incentive to file derivative actions. This is especially the case for minority shareholders in listed companies. On the one hand, minority shareholders normally own a very small percentage of shares each; the accumulation of one percent of share capital is not easy. On the other hand, the share price of Chinese listed companies is generally regarded as irrational, in that it does not reflect the true value of the company; therefore, the shareholders may not be compensated by an increase in share price resulting from the success of the suit.

Nevertheless, we should also note that some minority shareholders are willing to initiate derivative actions for the public interest in spite of these negative factors. The plaintiff shareholder in the *Sanjiu* case is such an example.

5.4.4.2 The attorney's role

Attorneys may play an important role in encouraging derivative actions, especially derivative actions with regard to listed companies. On the one hand, the special fee agreement between the plaintiff and the attorney, which is similar to the American contingency fee arrangement, may reduce the financial burden on the plaintiff to a certain degree. On the other hand, attorneys may play an important role in gathering minority shareholders together, especially those of listed companies, in order to satisfy the standing requirements under article 152. This can be seen from the development of private securities litigation. Several lawyers have actively encouraged such cases through various means such as running advertisements to gather potential plaintiff shareholders, or by taining a website with extensive information regarding securities litigation.[158]

5.4.5 Limiting directors' financial exposure to the risks and costs of litigation

In current Chinese company law there are neither regulations on capping directors' compensation to the company, nor regulations on whether it is possible for the company to reimburse the directors or officers for litigation costs that are related to the performance of their duties. Therefore, directors may face huge financial liabilities if they lose a case. Worse, they might also end up bearing the litigation costs of both parties.[159]

Directors and officers in China may be financially protected if the company buys D&O insurance for them. In article 39 of the CSRC's 'Code of Corporate Governance for Listed Companies' which is effective as of January 7, 2002, the listed company can buy liability insurance for its directors upon the approval of the shareholders' general meeting, except for directors' liability which arises from a directors' violation of statutes, legal regulations and the articles of association. The first D&O insurance policy in China was signed on January 24, 2002, just after the Supreme People's Court published 'Several rules on adjudicating civil lawsuits against listed companies on grounds of false statements' on January 15, 2002.[160]

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158 Song Yixin, a lawyer famous for protecting minority shareholders' interests, established the first website serving securities litigation in May 16, 2002 http://www.syxlawyer.com.cn; see http://www.imm.cn/pendingDelete/2005-5-16.htm, (last visited March 23, 2006). However, the website was closed down on May 31, 2005; see http://www.imm.cn/Delete/2005/20050531.htm (last visited March 23, 2006).

159 For details of litigation costs, see Section 5.4.4.1.

160 http://www.cctv.com/news/financial/20020124/201.html (last visited: October 2006).

5.4.6 *The 'abuse of rights' doctrine as a method of preventing the abusive use of derivative actions*

Article 20 of Company Law 2006 stipulates that no shareholder of a company shall abuse his rights in order to damage the interests of the company or of other shareholders, otherwise he will be held liable for compensation if the company or other shareholders suffer losses due to his abuse of rights. Theoretically, this provision may be used in derivative actions to prevent strike suits. However, whether Chinese courts will apply this article to deter derivative actions is still unknown.

5.5 Conclusion

5.5.1 *The function of derivative action in Chinese corporate governance*

That Company Law 2006 regulates derivative action has been widely welcomed. Since it is common for the interests of the company and minority shareholders to be infringed upon, and since there are hardly any effective alternative remedies, the derivative action is intended to play an important role in protecting the company and minority shareholders. However, due to vagueness in article 152 and other factors such as the competence of courts to hear such cases, it is doubtful whether derivative actions will be playing the role expected. Nevertheless, as mentioned in Section 5.2.2.4, we may expect that derivative actions will play a more important role in limited liability companies than they will in listed companies.

Another issue that Chinese lawyers should consider, as far as the function of derivative actions is concerned, is whether derivative actions should play an important role in solving conflicts between controlling and non-controlling shareholders. Although article 152 is vague as to whether the misconduct of controlling shareholders should be a cause of derivative action, judicial practice concerning derivative actions and the serious problem of the controlling shareholders' abuse of power may yet show that article 152 should permit derivative actions against the misconduct of controlling shareholders. In fact, we may even further anticipate that derivative actions are going to be playing an important role in solving these conflicts. However, as we know, derivative actions may have built-in defects in solving such conflicts. Comparative study also shows that derivative actions are not the major mechanism for solving such conflicts. On the contrary, there are better alternative mechanisms, such as *ex ante* prevention of abuse of power and an individual shareholder's direct action against the wrongdoing shareholder in limited liability companies, even in cases where the company is the party which has suffered the losses. Therefore, alternative mechanisms should also be developed in China in order better to reduce conflicts.

Although Company Law 2006 already reinforces some of these mechanisms, there are still insufficient numbers of them.

5.5.2 *The Chinese model for striking a balance between corporate efficiency and the protection of the interests of the corporation and its minority shareholders*

5.5.2.1 *The appropriate body for making corporate litigation decisions*

As in the Western countries we studied, in China the board of directors is also the body that makes corporate litigation decisions under normal situations. However, due to the principle of the legal representative, it is possible that the board's decision to sue may not be enforced by the legal representative and therefore the company may not recover its losses.

In Chinese company law, there is no regulation of the right of the shareholders' meeting to file an action in the name of the company. Theoretically, they should have that right. Even if they do not, they can remove the directors and appoint new ones, and thus the new directors can file the corporate actions. In practice, however, since the controlling shareholders normally control both the shareholders' meeting and the board of directors, it hardly ever happens that a shareholders' meeting and a board of directors have different opinions.

Although minority shareholders (an individual shareholder in limited liability companies and a group of shareholders in stock companies) are granted the power to bring derivative actions, the role of minority shareholders in making a corporate litigation decision is not clear due to the vagueness of article 152 regarding the effect of the demand requirement. For the same reason, the court's role in the corporate litigation decision is unclear as well.

We should also note that, unlike the situation in Germany, the supervisory board, or the supervisors where no supervisory board exists, has no power to make corporate litigation decisions by itself, even though it has assumed the function of supervision. According to articles 54(6) and 119, it can only 'bring a lawsuit against the directors or senior executives in accordance with the provisions of article 152 of this Law'; that is, it can only bring a lawsuit based on the minority shareholders' request. This lack of power to make corporate litigation decisions independently undoubtedly reduces its supervisory function.

5.5.2.2 *A fair balance between corporate efficiency and protection for the company and minority shareholders*

Undoubtedly, Chinese legislators have made an effort to strike a fair balance between corporate efficiency and protection for the company and minority shareholders. This can be seen from article 152 of Company Law 2006. While article 152 provides the mechanism of derivative actions to protect the company and minority shareholders, at the same time it has also been carefully designed so

as to prevent the abuse of derivative actions and prevent any unjust interference with corporate management.

However, does Chinese company law strike a fair balance between corporate efficiency and protection for the company and minority shareholders? The answer may be grounds for pessimism. It appears that in order to strike a fair balance, article 152 has tried to learn from Western countries. For example, it has adopted experiences found both in German law (the capital threshold in stock companies and the role of the supervisory board in making corporate litigation decision) and in American law (the period of shareholding and the demand requirement). Nevertheless, Chinese company law may have defects both in facilitating derivative actions and in protecting corporate management. On the one hand, minority shareholders in stock companies may face high thresholds and so have difficulties in initiating derivative actions; in addition, high litigation costs may also deter derivative actions. On the other hand, corporate management may not be sufficiently protected. This can be viewed from two angles. First, directors, supervisors and senior officers may be exposed to the risk of huge financial liability since there is a lack of protection, such as the business judgment rule, as well as a lack of limitation of their financial liability. Second, the only obstacle to shareholders who do satisfy the standing requirements in article 152 and want to bring derivative actions is the demand requirement; however, article 152 is unclear as to the effect of the demand requirement. As a result, due to these defects in the Company Law, it is possible for derivative actions to be abused by qualified shareholders in order to interfere with corporate management, with the result that the interests of the company and minority shareholders are not protected.

In order to strike a fair balance between corporate efficiency and protection for the company and minority shareholders, the rules on relevant issues, such as the right of minority shareholders to information, should also be improved. After all, it is generally acknowledged that for enforcement of a derivative action, a comprehensive system needs to be constructed.

5.5.2.3 The court's role in derivative actions

It is still unclear what degree of discretion the Chinese court will have in hearing derivative actions. Although the international trend shows that courts are awarded a great deal of discretion in derivative actions, the problems of Chinese courts may prevent China from following this recent international trend.

Chapter 6
Conclusion

6.1 The function of derivative action

6.1.1 Conclusions from the comparative study of England, the United States and Germany

Several conclusions may be drawn as far as the role of derivative actions in England, the United States and Germany is concerned.

Different roles for derivative actions in these countries

It is obvious from comparative study that derivative actions play different roles in these countries. Derivative actions play a major role in the United States, while in England and Germany they are rarely applied. The function of derivative actions in each country depends on many factors, such as legal traditions, policy considerations and the availability of alternative mechanisms capable of providing protection for minority shareholders.[1] For example, traditionally both England and Germany are more concerned about the disadvantages of derivate actions than with their advantages and so focus on corporate efficiency rather than on protection of the company and minority shareholders. As a result, stringent requirements for initiating derivative actions have been established making it quite difficult for derivative actions to play any important role.[2] In the United States, on the other hand, the attitude towards private litigation is more positive than it is in England and Germany, and as a result, derivative actions are quite important in corporate governance.[3]

Although it is still an open question as to what function derivative actions should have, there does seem to be a trend towards convergence regarding this issue. Both England and Germany have reformed the law in order to facilitate derivative actions[4], while in America rules to restrict derivative actions have been

1 For factors affecting the function of derivative action, see Section 1.4.3.

2 For the English attitude towards the derivative action, see Section 2.2.1; for the German attitude, see Sections 4.2.1 and 4.2.2.

3 For the American attitude towards the derivative action, see Section 3.2.

4 For an introduction to the reforms in England and Germany, see Sections 2.1.5 and 4.1.2 respectively.

developed.[5] Although derivative actions are unlikely to play similar roles in practice in any of these countries even after the reforms, this trend at least shows that it is commonly recognized that derivative actions should play an important, albeit limited role.

The influence of the agency problems to be resolved and the type and size of the companies involved

The function of derivative actions may vary according to the agency problems needing to be resolved as well as the type and size of the companies. To begin with, derivative actions may be less effective in resolving the majority/minority shareholder conflict than they are in resolving the shareholder/director conflict. As we have mentioned, the nature of derivative actions requires that the recovery be awarded to the injured company.[6] This corporate recovery, however, may be problematic where the wrongdoer is a majority shareholder. Since it is difficult to expel the wrongdoing majority shareholder from the company or to loosen his grip on power, the recovery awarded to the injured company ends up still being under his control. In addition, he will indirectly benefit from any corporate recovery simply through the shares he owns. Thus, the dual function of compensation and deterrence may not be achieved.

However, the above-mentioned ineffectiveness does not mean that a derivative action is no longer viable against the controlling shareholder's misconduct towards the company. On the contrary, in principle the justifications for a derivative action still exist, especially against one-shot misconduct. Nevertheless, there may be exceptions. For example, in owner-managed companies, where the real conflict is between the majority and the minority shareholders, the justifications for a derivative action may not exist at all.[7] Generally such a company is characterized by rather distinctive features. For example, there might only be a few shareholders who could be divided into the two necessary groups of plaintiffs and defendants, the shares might not be publicly transferable, or the company might be managed by the shareholders. Indeed, as DeMott points out, in such a company 'the distinction between the interests of the corporation as an entity and interests of its shareholders may seem more formal than real'.[8] Where such a company is injured by the majority shareholder, it is the minority share-

5 For the development of the American law on derivative action, see Section 3.1.1.

6 See Section 1.1.

7 Since the legal standards for the classification of companies are different in every country, I will use the classification devised by Davies in order to avoid misunderstanding. Davies divides companies into four types: the owner-managed company; the large private company; the public company whose shares are not publicly traded; and the public company whose shares are traded on a public market and whose activities are thus additionally regulated by the rules of that market, see Davies (2002), p. 27. As far as a derivative action is concerned, identification of the first type of company, the owner-managed company, is important.

8 DeMott (2003), Section 2, pp. 2-34 (2-35.

holders who are actually injured and therefore the real dispute is among shareholders rather than between the wrongdoing shareholder and the injured company. In addition, due to the special features of owner-managed companies, justifications for a derivative action may simply not exist. For example, since generally there are no non-party shareholders, problems of multiplicity of suits and of prejudice to other non-party shareholders, in cases where individual remedies are given, will not exist. As long as the company is not bankrupt, the interests of creditors and other stakeholders will not be injured, even if the damages do not go to the company.

The ineffectiveness of derivative actions in solving the conflict between majority and minority shareholders, along with the special features of owner-managed companies, make derivative actions less important in such companies, if not absolutely unnecessary. Practice in Western countries also shows that derivative action is not the major remedy for the aggrieved minority shareholders in owner-managed companies when the company has been injured, even if there are non-party shareholders. Instead, direct remedies play a more important role. For example, in England a minority shareholder can directly apply the unfair prejudice procedure in order to challenge the majority shareholder's misconduct towards the company.[9] In the United States, where a close corporation has been injured by the majority shareholder, the court may identify causes of direct action by relying on 'the broadened involuntary dissolution remedy' or 'the enhanced fiduciary duties owed by the controlling shareholder to other shareholders'.[10] The court may also allow a direct action where, in a public corporation, a derivative action would have to be brought.[11] As a result, the plaintiff minority shareholder of a close corporation may be awarded direct remedies where the corporation has been injured. In Germany, there is no statutory derivative action in the GmbHG and the case law mechanism of *actio pro socio* only plays a limited role.[12] In order to provide protection for minority shareholders against majority shareholders, German case law imposes fiduciary duties with regard to the company and other shareholders upon the majority shareholders, and grants remedies of dissolution, withdrawal and expulsion to the aggrieved shareholders.[13]

Nevertheless, we should also note that by adopting different mechanisms to redress the majority shareholder's misconduct towards the company, each country provides a different degree of protection for the aggrieved minority shareholders in owner-managed companies. For example, in the United States, a minority shareholder is able to bring a derivative action against the majority shareholder's misconduct towards the company[14], and it is relatively easier to satisfy the

9 See Section 2.2.2.
10 See Section 3.2.3.4.
11 See Section 3.3.3.2.
12 See Section 4.1.3.2.
13 See Section 4.2.3.2.
14 See Section 3.4.1.1.

requirements for bringing a derivative action in such situations.[15] He may also seek remedies based on the mechanisms of 'oppression' or the majority shareholder's 'breach of fiduciary duty'.[16] In addition, some courts may treat the derivative action case flexibly and allow a direct action in such situations and thus the aggrieved minority shareholder will obtain an individual recovery.[17] In short, the minority shareholder is well protected: he can be compensated for the injury directly via the individual recovery or indirectly via the corporate recovery, or he may choose to exit the company.

English law also provides good protection for minority shareholders in such circumstances, due to the recent development of the unfair prejudice remedy. The recent development of the unfair prejudice procedure shows that English courts are willing to apply this procedure where the company suffers the injury and may compensate the aggrieved minority shareholder for his reflective losses, in addition to granting him the right to exit the company.[18] In fact, English courts are granted wide discretion to award relief as they think fit.[19] This wide discretion in general ensures protection for aggrieved minority shareholders, provided the court is competent and impartial. This is generally the case in England. In addition to the unfair prejudice remedy, an aggrieved minority shareholder may also bring a derivative action against the majority shareholder's misconduct towards the company if he satisfies the requirements for bringing such an action.[20] Although the derivative action is in general not attractive for minority shareholders, it at least provides a solution.

The aggrieved minority shareholders of a German GmbH also have an exit remedy where the majority shareholder injures the company, just as do their counterparts in the United States and England.[21] However, they may not be fully compensated in such circumstances since the cause of action for the compensation belongs to the company and it is difficult for the minority shareholder to bring an *actio pro socio* on behalf of the GmbH against the wrongdoing majority shareholder.[22] In addition, since the aggrieved shareholders who withdraw from the company can only acquire market value for their shares[23], they may not be fully compensated if they choose to exit the company. In this sense, minority shareholders of German GmbHs are not in as good a position as their counterparts in England or the United States are.

15 It is easier to plead demand futility for close corporations. See Thompson & Thomas (2004), p. 1784.
16 See Section 3.2.3.4.
17 See Section 3.3.3.
18 See Section 2.2.2.
19 See Section 2.2.2.1.3.
20 See Section 2.4.1.
21 See Section 4.2.3.2.
22 See Section 4.1.3.2.
23 There is no explicit definition of 'market value' in German law; nevertheless, it may not compensate the withdrawing shareholders for the indirect losses reflected in the GmbH's losses, which have not been claimed by the GmbH.

Derivative action as part of a comprehensive system of corporate governance

As I already indicated, the derivative action is only one of the many mechanisms for disciplining corporate management and protecting minority shareholders. Due to factors such as legal traditions and corporate structures, the major mechanisms for improving corporate governance are different in the various countries and derivative action does not necessarily play a similar role. For example, both in England and Germany, where derivative action hardly has any function in corporate governance, there are other mechanisms that provide protection for the company and minority shareholders.[24] In fact, the role of derivative action is inversely proportional to the availability and effectiveness of other mechanisms: the more effective other mechanisms are, the less important the function of the derivative action is. Of course, the experiences of all three countries also show that no mechanism can completely substitute for another one, including the derivative action. Due to this comprehensive system of corporate governance, it simply cannot be asserted that any one of the countries provides a better solution than any of the others, as far as the function of the derivative action is concerned.[25]

6.1.2 The purpose of derivative actions in China (suggestions for China)

As we know, before Chinese Company Law 2006 there were no statutory rules for derivative action and derivative action did not play an important role in protecting injured companies and minority shareholders.[26] However, this has changed. Now that the derivative action has been adopted in Chinese Company Law 2006, the Chinese legislature, in addition to scholars and practitioners, anticipates that the derivative action will play an important role in corporate governance. It should be noted, though, that this expectation is based on the poor position of minority shareholders, as well as on the shortage and ineffectiveness of other corporate governance mechanisms, rather than on a comprehensive understanding of the advantages and disadvantages of derivative actions.

A comparative study of Western countries generates two questions with regard to the function of derivative actions in China. The first issue is whether the derivative action will be able to play this anticipated role in China. As we have already observed in the comparative study, many factors can affect the application of the derivative action, such as legal rules and norms, legal tradition, policy considerations and the availability of other mechanisms.[27] These factors surely

24 For English law see Section 2.2.1; for German law see Section 4.2.3.

25 For a good comparison of the strategies applied in these countries as well as in some other countries, see Kraakman et al. (2004).

26 See Sections 5.1.2.1 and 5.2.1.

27 See Sections 2.2, 3.2 and 4.2.

will also affect the application of the derivative action in China. In fact, there are several factors that may promote the use of the derivative action, such as the poor position of minority shareholders and poor corporate governance, while there are also several factors that may impede the function of derivative action, such as the relatively poor quality of the courts and the plaintiff shareholder's under-incentive problem.[28] Nevertheless, we can still expect that derivative action will eventually play an important role, since there are few alternative remedies available for the injured company and minority shareholders.

We should also note that derivative action may be expected to play a more important role for Chinese limited liability companies, which to a certain extent are equivalent to close corporations or private companies, than it will for Chinese stock companies, especially those listed companies.[29] Several factors may account for this. For example, the Chinese legislature and courts are taking a more cautious approach towards the derivative action for stock companies; the threshold for minority shareholders of stock companies wishing to bring a derivative action is higher than that that for minority shareholders of a Chinese limited liability company; there are no alternative remedies such as an exit right for the minority shareholders in a limited liability company; and a minority shareholder in a limited liability company may have more interest in a derivative action than does a shareholder in a listed company, since the latter may only have a small stake in the company.[30] The expectation that derivative action will play a more important role in limited liability companies is reflected in current judicial practice, since most of the derivative action cases heard by the courts so far concern limited liability companies.[31] However, the more important role that derivative action might come to play in Chinese limited liability companies may be inconsistent with present-day international trends and result in insufficient protection for minority shareholders. This actually is the second issue as far as the function of derivative action in China is concerned. Based on the experience of Western countries, we may draw the conclusion that although at present the derivative action will and should play an important role in Chinese limited liability companies due to the lack of other remedies, this should not be the direction of future development. Instead, in the future China should also develop mechanisms that provide direct remedies for aggrieved minority shareholders in limited liability companies, in order to provide better protection for them at the outset.

We should also consider what function the derivative action should play in Chinese stock companies. Although Western countries do not provide a uniform answer, practice does show that whether the derivative action should be important or not depends on the special situation of each country. Based on the Chinese

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28 See Section 5.2.2.
29 See Section 5.2.2.4.
30 See Section 5.2.2.4.
31 See Section 5.1.2.1.2.

situation, we suggest that derivative actions should play an important role for stock companies because of serious problems with Chinese corporate governance and the poor protection given minority shareholders and also because of the lack of other effective mechanisms. For example, due to the traditional Chinese Guanxi (relationship) culture, supervision of corporate management by an independent body is unlikely to be successful. Of course, for derivative actions to develop such an important role, China would have to improve its judicial branch, as the success of derivative actions to a great extent depends on the courts. Moreover, we should also note that the role of the derivative action should not be exaggerated, especially since in China controlling shareholder and majority/minority shareholder conflict is common even in the largest listed companies. Due to the defects inherent in derivative actions when solving such conflicts, other methods should also be developed in order to improve corporate governance as a whole.

6.2 The distinction between derivative actions and direct actions

6.2.1 Conclusions from the comparative study of England, the United States and Germany

Due to restrictions on his right to initiate a derivative action and due to the corporate recovery should the derivative action succeed, the minority shareholder would normally prefer to bring a direct action rather than a derivative action, despite the advantages he may well have in a derivative action.[32] In other words, a minority shareholder is generally in a better position if he is allowed to bring a direct action against the misconduct.

Comparative study of Western countries shows that normally the injury standard and/or the right standard are applied in order to distinguish a shareholder's direct action from a derivative action.[33] In most cases the employment of the injury and the right standards do not lead to different results based on this distinction, since legal rights and injuries normally relate to one another.[34] Therefore, in order to make the distinction, the identification of the shareholder's personal rights[35] or personal losses as something separate from the corporate rights or losses, is very important. How such identification is made is regulated by the substantive law of

32 For example, he may be reimbursed for his litigation costs by the company in a derivative action.

33 See Sections 2.3.1, 3.3.1 and 4.3. However, American law may sometimes consider other factors, such as policy considerations when making the distinction, see Section 3.3.1.2.

34 See Section 3.3.1.1.1.

35 Sometimes it is the defendant's duty that needs to be determined since 'rights correspond with duties', see Welch (1994), p. 163.

each country. In many cases the line between the shareholder's personal rights and corporate rights is clear, while in many other cases it is not. The difficulty in making this clear identification stems mainly from three legal rights: the right of claims against defective resolutions of the company (or breach of the constitution), the right of claims against the director's breach of duty, and the right of claims against the shareholder's breach of duty.

However, there are also circumstances where the infringement of rights may not be identical to the injuries suffered. Therefore, the application of the injury standard and the right standard may lead to different results as far as the classification of the nature of the litigation is concerned. For example, sometimes the infringement (or a prospective infringement) of rights may lead to no injury to the company, while sometimes an injury to the company may infringe both the rights of the company and of shareholders individually. The latter is frequently the case in owner-managed companies. Where the misconduct against the company causes no injury to the company or where corporate injury does occur but where the litigation claims for non-pecuniary remedies such as an injunction or a setting aside of defective resolutions rather than for damages, Western countries may allow a shareholder to bring a direct action, subject to the principle of non-interference with corporate management.[36] In fact, the very scope of the individual shareholder's right to bring such a direct action is different in these countries precisely due to the different applications of the principle.[37]

Where an injury to the company infringes the individual shareholder's personal rights as well as the corporate rights, Western countries take differing approaches towards the classification of these actions. Although all the countries accept the general principle that an individual shareholder cannot bring a direct claim for his reflective losses, some countries may apply this principle flexibly, especially in the case of owner-managed companies, while others may not. For example, in the United States, some courts require an individual shareholder to bring a derivative action in order to claim for damages against the corporate injury. However, other courts take a more flexible approach and allow for a shareholder's direct action to claim for personal damages in close corporations, where, in public corporations, the claimant might well have brought a derivative action.[38] In England, this distinction is actually moot due to the popularity of the unfair prejudice procedure.[39] Since German law basically adheres to the general principle of no reflective loss, the nature of the action depends on the remedies sought. An individual shareholder can bring a direct action against the injury to the company if his claim is based on a personal remedy such as withdrawal. However, if he wants to claim compensation, he has to bring a derivative action.[40]

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36 See Sections 2.3, 3.3 and 4.3.

37 For the scope of this individual shareholder's right in each country, see Sections 2.3.2, 3.3.2.1 and 4.3.1.

38 See Section 3.3.3.

39 See Section 2.2.2.1.2.

These varying approaches have their own advantages and disadvantages. For instance, the flexible approach taken by the English courts and some American courts may provide better protection for minority shareholders. However, this approach at the same time requires competent and fair judges to hear these cases since identification of the nature of the litigation under the flexible approach has to be done on a case-by-case basis. Although the German approach may require less court discretion, it may not redress the wrong due to the difficulty in bringing a derivative action.

6.2.2 Suggestions for China

Several defects in current Chinese company law may be identified as far as the distinction between shareholders' direct and derivative actions is concerned. First, the substantive law concerning the shareholder's personal rights or in regard to the duties owed to individual shareholders is not clear.[41] This can make it difficult to draw distinctions. Therefore, future reform should clarify the substantive law. Second, under Chinese Company Law 2006 an individual shareholder has a wide-ranging right to initiate a direct action in order to set aside defective resolutions of corporate bodies, no matter whether his personal rights have been infringed or not.[42] Although there are restrictions on it, this right may unjustly interfere with corporate management. Therefore, Chinese company law should also introduce the principle of non-interference with corporate management and restrict this right of individual shareholders, for example, by requiring that an individual shareholder only bring such an action where his personal interests have been infringed or where the misconduct challenged involves serious mismanagement. Third, some rights (or duties) under current Chinese company law are not coupled with remedies and so, as a result, no action may arise from the breach of duties. For example, although a shareholder owes fiduciary duties to other shareholders, a breach of duties does not necessarily give rise to a direct action by the aggrieved shareholders as there is no remedy for the aggrieved shareholders except where they have suffered direct losses.[43] Therefore, in order to prevent these rights from becoming only paper tigers, future Chinese company law should provide minority shareholders with direct remedies against infringement of rights. Due to these defects, it is currently more appropriate in China to apply the injury standard when identifying the nature of the shareholder's action. However, when the above defects have been remedied, the right standard should prevail in those cases where it is inconsistent with the injury standard.

Chinese law is also faced with the issue of whether or not it should take a flexible approach towards the distinction between direct and derivative action in

40 See Section 4.3.3.
41 See Sections 5.1.1.4.3.2, 5.3.2 and 5.3.3.
42 See Section 5.3.1.
43 See Section 5.3.3.

owner-managed companies. This is actually an open-ended question because comparative study does not provide any conclusive answer and because the very development of the Chinese judicial system still remains to be seen.

6.3 Maintaining a fair balance between corporate efficiency and protection for the company and minority shareholders

6.3.1 General comments

The Western countries we have studied have taken differing approaches towards striking a balance between corporate efficiency and protection for the company and minority shareholders. Generally, both in England and Germany, this balance favors corporate management, while in the United States it is easier to bring a derivative action.[44] However, in spite of these different approaches, the basic strategies for striking a balance which have been adopted by these countries are similar, as they are all faced with the same problems derivative action causes. This has provided the foundation for our comparative study. Traditionally these countries have adopted different solutions to these problems; however, more recent reforms in these countries now show a trend towards convergence in many respects.

This comparative study illustrates the fact that the application of derivative actions is affected by a wide range of legal rules, including the specific legal rules for derivative actions, the legal rules which, while not specific to derivative actions, do have a direct influence on derivative actions, and a broader group of legal rules including rules on corporate governance.[45] It is important for China to recognize this influence stemming from a wide range of legal rules since China has been focusing on specific legal rules for derivative actions while neglecting the influence of other rules.

Due to its limited scope, this book could not discuss all of these legal rules but has focused mainly on the first group of rules and some rules from the second group. Among these are some issues which are especially important for improving Chinese law on derivative actions, so I will be discussing these in the following sections.

44 See Sections 2.2, 3.2 and 4.2.

45 See Section 5.2.2.2.

6.3.2 *The appropriate body to make a litigation decision in the best interests of the company*

6.3.2.1 *Conclusions from the comparative study of England, the United States and Germany*

As this comparative study has shown, all countries are faced with the issue of the appropriate body to make a litigation decision in the best interests of the company, especially where public companies are concerned. While in owner-managed companies the difficulty lies in determining whether the controlling shareholder's misconduct against the company should give rise to a direct or a derivative action, in other companies, especially in public companies, the real difficulty lies in identifying the appropriate decision-making body, where the board of directors has a conflict of interest when making a corporate litigation decision.

Comparative study has demonstrated that several strategies to handle this have been developed in the three countries discussed and that these have resulted in different bodies, such as the shareholders' general meeting, an independent corporate body, minority shareholders, or the court, making such a decision. Each of these bodies has its own advantages and disadvantages when making the decision. For example, under the decision-making strategy, the general meeting of shareholders generally has the right to make a litigation decision in the name of the company, but this strategy has the defect of collective action, which, especially in publicly held companies, makes the decision-making process slow and costly. Moreover, where the majority of shareholders are also the wrongdoers or where they control the wrongdoers, the problem of conflict of interest may well arise. Disinterested shareholders, when substituting for the general meeting, have the advantage of avoiding the problem of conflict of interest, but the problem of collective action is not resolved; in small companies there may not even be any disinterested shareholders. The minority shareholders' right to enforce corporate claims (the derivative action) may solve the above-mentioned problems, but may generate the new problem of interfering with corporate management and create the problem of shareholder incentive.[46] Trusteeship strategies are not perfect either. Internal trustees, such as the independent directors, may have the advantage of expertise and knowledge of the company's affairs, but they may not be sufficiently independent or may actually be structurally biased. Outsider trustees have problems as well. For example, the courts, although independent, are not business experts and, as outsiders, may not be the appropriate body to make a decision for the company; besides, a judicial process normally costs a great deal of time and money.

Since no strategy is perfect, it is difficult to choose the appropriate body to make a litigation decision in the best interests of the company where the board

46 See Section 1.3.

has a conflict of interest. In fact, several factors may affect the choice, such as the type and size of the company[47], the shareholding of the company[48], effects arising from the application of the strategies[49], or even policy attitudes towards the issue, for example, the policy of favoring the collective nature of corporate litigation decisions.[50] It is also common for more than one strategy to be adopted in order to achieve a better effect. For example, the minority shareholder's right to bring a derivative action is normally combined with judicial discretion in order to permit the continuance of the action.[51]

Western countries have traditionally taken different approaches towards the issue of the appropriate body. Nevertheless, recent reforms in these countries also show a trend of convergence. For example, England traditionally has always recognized that the general meeting of shareholders has the right to make a corporate litigation decision and that an individual shareholder can bring a derivative action only in exceptional cases. Recently, however, English law has identified two other bodies which may make this decision: an independent body of the company and the court. Based on the policy of favoring the collective nature of corporate decisions, an independent body of the company is regarded as being more appropriate than an individual shareholder when making such a decision.[52] Moreover, the court's permission is required in order for the individual shareholder to continue the derivative action.[53] It has even been recently suggested that the court's role should be improved. The Companies Bill suggests that the court be given greater discretion in deciding whether to permit a derivative action.[54] However, this reform will not change the tradition of regarding an individual shareholder's right to bring a derivative action as a last resort.[55]

Unlike in England, an individual shareholder's derivative action has traditionally played an important role in the United States.[56] Nevertheless, the development of the special litigation committee has to a large extent transferred the power from the individual shareholder to the independent directors.[57] This development has also had the effect of giving the court more discretion to decide whether to allow a derivative action, since the courts in some states, such as Delaware, review the decision of the special litigation committee with a standard

47 Hirt (2005a), p. 200.
48 Hirt (2005a), pp. 201-202.
49 Hirt (2005a), pp. 200-201.
50 Hirt (2005a), p173. English law is an example of this, see Section 2.6.2.1.
51 Hirt (2005a), pp. 180-181. As noted below, this approach has been taken in England, in the US, as well as in Germany.
52 See Sections 2.1.3.3 and 2.4.1.3.
53 See Sections 2.1.4 and 2.4.1.2.3.
54 See Section 2.4.2.3.
55 See Section 2.4.2.
56 See Section 3.2.
57 See Section 3.4.2.2.2.3.3.1.

that is different from the standard applied when reviewing the board's decision. The court will usually apply the business judgment rule to review the board's litigation decision, while, when reviewing the decision of the special litigation decision, it will exercise more discretion, such as applying its own business decision.[58]

German law has its own features regarding this issue.[59] First of all, German law provides different solutions to the issue depending on whether AGs or GmbHs are involved. Second, the supervisory board, which is regarded as being independent from the managing board, has taken on the task of making a litigation decision against members of the managing board, and this has been recognized for quite a while now. In GmbHs, where no supervisory board exists, the shareholders' general meeting can make such a decision. Third, in AGs the general meeting of shareholders as well as a group of minority shareholders also have the right to make litigation decisions. Fourth, there is no priority as far as these bodies' power to make a litigation decision is concerned. In other words, one body's negative litigation decision will not bar another body's right to make a decision. Fifth, accepting the experience derived from the common law countries, the UMAG has also granted the court greater discretion in deciding whether to allow a shareholder's derivative action.

The development of the above-mentioned laws obviously shows a trend towards convergence in spite of their different approaches: the countries all recognize that more than one body should be given the power to make such a decision and, of these bodies, it is the court that should be awarded wide discretion to decide whether it is in the best interests of the company to sue.

6.3.2.2 Suggestions for China

One defect of the Chinese law on derivative actions is that it fails to consider several fundamental issues or principles regarding derivative actions. Identifying the appropriate body is one of those issues that have been ignored.

The issue of choosing an appropriate body is pivotal to the application of derivative actions since the negative litigation decision of a body, if this body is regarded as being more appropriate than the minority shareholders for making a litigation decision, may bar a derivative action. In fact, as we have observed, many of the rules regulating the issue of the appropriate body are embodied in the requirements for bringing a derivative action. Unfortunately, Chinese law is rather vague as far as this issue is concerned. This vagueness, for example, can be observed when examining the following aspects. First, article 152 of Company Law 2006 requires that, before they initiate a derivative action, the minority shareholder(s) make a demand on the supervisory board or the board of directors,

58 See Section 3.4.2.2.2.3.3.2.

59 For a detailed discussion of the German law, see Section 4.1.3.

which is supposed to have no conflict of interest regarding the litigation decision. However, if article 152 is interpreted literally, a negative litigation decision by either of the boards will not bar the derivative action.[60] Therefore, the minority shareholder(s) are not regarded as being less appropriate to make such a decision than the board, which is regarded as independent. The purpose of this demand requirement seems to revolve around preventing multiplicity of litigation rather than subjecting the minority shareholders' will to the board's business decision.[61] This approach may result in the minority shareholders interfering with corporate management by bringing a derivative action.[62] Second, although article 152 requires that the minority shareholder(s) make a demand on the supervisory board or on the supervisors (in those limited liability companies where no supervisory board exists), the supervisory board or the supervisors can only bring a corporate action against the directors or senior executives on the basis of the minority shareholders' request.[63] In other words, the supervisory board or the supervisors cannot make an independent litigation decision. This approach, together with the effect of the demand requirement, could lead one to conclude that the supervisory board or the supervisors are not regarded as an appropriate body to make a corporate litigation decision under Chinese law. Third, the court's role in making a corporate litigation decision is not clear either. On the one hand, Company Law 2006 does not grant the court any discretion as to permitting a derivative action or reviewing the boards' decision.[64] On the other hand, however, judicial practice shows that the court may actually have this discretion in practice.[65]

This vagueness will obviously cause problems such as uncertainty and inconsistency in the implementation of the law. Therefore, China should find a solution to this issue on the basis of the particular situations found there.

6.3.3 The principle of non-judicial interference with corporate management

6.3.3.1 Conclusions from the comparative study of England, the United States and Germany

The comparative study shows that it is a generally recognized principle that corporate management should not be unjustly interfered with, either by a shareholder's direct action or by his derivative action. Following this principle, all Western countries acknowledge that a shareholder can only bring litigation against certain kinds of corporate mismanagement.

60 See Section 5.4.2.3.
61 See Section 5.4.2.3.
62 See Section 5.4.2.3.
63 See articles 54(6) and 119 of Chinese Company Law 2006.
64 See Section 5.4.2.3.

As far as the derivative action is concerned, this principle is mainly embodied in the substantive restrictions placed on the shareholder's right to initiate a derivative action. These are the restrictions placed on the possible defendants in a derivative action (or, in other words, those whose misconduct may be the cause of derivative action) and the restriction placed on the nature of the misconduct which may give rise to a derivative action. The approaches towards these restrictions may differ in Western countries. For example, with regard to the restriction on the possible defendants, the difference mainly lies in whether the controlling shareholder's misconduct may be a cause of derivative action. Under American law and English common law, a derivative action may be initiated against the controlling shareholder's misconduct.[66] Nevertheless, the British Companies Bill suggests that the cause of derivative action should only arise from the director's misconduct.[67] The German law has also changed its approach, but in another direction. Before the UMAG, basically only the director's misconduct could be a cause of derivative action[68], however, the UMAG has extended the causes to include the shareholder's misconduct as well.[69] These different approaches may provide different degrees of protection for the injured company and minority shareholders. If a derivative action is not permitted against the controlling shareholder's misconduct, the injured company and the aggrieved minority shareholders may not be well protected, since the board, which is normally under the control of the wrongdoing controlling shareholder, is unlikely to bring a corporate action against the misconduct. However, we should note that currently only the British Companies Bill suggests that a derivative action should be initiated only against the director's misconduct. That said, the disadvantage of the approach taken by the British Companies Bill may not be significant in England because the controlling shareholder may qualify as a shadow director and because, more especially, the minority shareholders can be protected against the wrongdoing shareholder via the unfair prejudice petition.[70]

Different approaches have also been taken towards the nature of misconduct that may give rise to derivative actions. One approach is that the law lays down restrictions *ex ante* that only certain kinds of misconduct can give rise to derivative actions. This approach has been adopted, for example, by English common law and the German UMAG.[71] The American business judgment rule plays a similar role by shifting the burden of proving certain misconduct onto the plaintiff.[72] Nevertheless, we should note that the scope of actionable misconduct varies in these countries. The other approach revolves around no *ex ante*

65 See Sections 5.1.1.4.2.4 and 5.4.2.1.
66 See Sections 3.4.1.1 and 2.4.1.1.1 respectively.
67 See Section 2.4.2.2.1.
68 See Section 4.4.1.1.1.
69 See Section 4.4.2.2.1.
70 See Section 2.2.2.
71 See Sections 2.4.1.1.2 and 4.4.2.2.1 respectively.
72 See Section 3.4.1.2.

restriction being established, but expects that the court will exercise its discretion when deciding whether a derivative action should be permitted. The British Companies Bill takes this approach.[73] As mentioned, each of these approaches has its own advantages and disadvantages.[74]

6.3.3.2 Suggestions for China

The principle of non-judicial interference with corporate management is important for striking a balance between corporate efficiency and protection for the company and minority shareholders. However, it would appear that Chinese law has not recognized this principle very well. The restrictions on minority shareholders' litigation mainly focus on prevention of abuse of litigation rather than on this principle. For example, an individual shareholder can bring a direct action to set aside defective resolutions of the board or of the shareholders' general meeting, even if there are only minor procedural defects[75]; the requirement that the plaintiff shareholder provide security is, to a great extent, intended to prevent the abuse of this right.

The Chinese law on derivative actions does not reflect this principle either. The restrictions placed on the minority shareholder's right to derivative actions are mainly procedural, such as the threshold requirement and the demand requirement. However, the substantive restrictions remain rather vague. For example, article 152 of Company Law 2006 allows a derivative action to be pursued against persons other than directors, supervisors and senior officers, but it does not clarify under what circumstances the derivative action is allowed against these persons. In other words, it is not clear whether the misconduct of these persons can be the cause of derivative action or not.[76] As far as the nature of the misconduct that may give rise to a derivative action is concerned, Company Law 2006 has no restriction except for the requirement that the misconduct of directors, supervisors and senior officers must arise during the course of performing their company duties.[77] That is, a director may be held liable for his mere breach of the duty of care when performing his company duties.

It is obvious that these vague substantive restrictions under Chinese law will make corporate management an easy target for minority shareholders, this will, in turn, negatively affect economic development and investors' interests. Therefore, China should introduce the principle of non-judicial interference in corporate management and improve the rules of substantive restrictions on derivative action.

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73 See Section 2.4.2.2.2.
74 See Section 5.4.1.2.
75 See Section 5.3.1.
76 See Section 5.4.1.1.
77 See Section 5.4.1.2.

6.3.4 *The procedural requirements for minority shareholders to bring a derivative action*

This comparative study shows that Western countries lay down different procedural requirements for minority shareholders to bring a derivative action. For example, English law requires that the minority shareholder prove *prima facie* the *Foss* rule requirements and obtain the court's permission in order to continue the derivative action.[78] American law requires the plaintiff shareholder to own the shares at the time the wrong was committed and to make a demand on the board before he initiates the derivative action.[79] German law has traditionally relied on the capital threshold requirement[80], but the latest UMAG inserts a new requirement of a two-stage court procedure. Therefore, the court's permission is needed in order for the minority shareholder(s) to continue the derivative action.[81] These requirements are all intended to prevent the abusive use of derivative actions and to maintain a balance between corporate efficiency and minority shareholder protection. Due to the different backgrounds of each country, it is actually difficult to conclude which approach is the best. In the end, the effect of the various procedural requirements should be evaluated against the whole system.

Chinese law also lays down procedural requirements for bringing a derivative action.[82] However, the effect of these requirements remains to be seen.

6.3.5 *The plaintiff's incentives to initiate a derivative action*

In Western countries there is still no satisfactory solution to the plaintiff's under-incentive and/or over-incentive problems. Nevertheless, there is no doubt that the allocation of litigation costs will to a great extent affect the plaintiff's incentives. In appropriate situations shifting the plaintiff's burden of litigation costs to the company, which is the real beneficiary of the suit, is a common way to reduce the under-incentive problem.[83] This should also be learned by China.

6.3.6 *The court's role in derivative actions*

Our study illustrates that the court has played a more and more important role in derivative actions in Western countries, including Germany where the court has traditionally played a less important role. The court has wide discretion not only in deciding the fiduciary duties of directors and controlling shareholders, but also in identifying the nature of the action and in deciding whether to allow a derivative action. This trend reflects one feature of company law. Due to the

78 See Section 2.4.1.2.
79 See Section 3.4.2.
80 See Section 4.4.1.2.
81 See Section 4.4.2.2.2.
82 See Section 5.4.2.
83 See Sections 2.4.1.4, 3.4.4.1 and 4.4.2.2.3.

different situations in every company and the difficulty in balancing the interests of the different parties, not to mention the overriding context of the rapid development of business society, company law should be sufficiently flexible. The best way to achieve this flexibility is to establish basic principles and grant the court wide discretion in implementing these principles on a case-by-case basis.

However, granting the court wide discretion is based on the premise that the court will be fair and competent to hear these cases. It is generally agreed that currently Chinese courts are not able to satisfy these requirements.[84] Therefore, improving the quality of the Chinese judicial branch will be important for the application of derivative actions and their future development.

84 See Section 5.2.2.3.1.

Summary

Where injuries have been done to a company, the general principle is that a suit against this misconduct should be pursued by that company and that damages should be awarded to that company. However, in certain circumstances (such as when the company is controlled by the wrongdoer and therefore cannot bring an action by itself), an individual shareholder or a group of minority shareholders of the injured company can bring a derivative action against this misconduct in their own name in order to protect the interests of that company and the shareholders thereof. This fact notwithstanding, this exception to the general principle may also have its disadvantages, for example, corporate management may be unjustly interfered with or the shareholders may not have sufficient incentive to bring the action. Because of both its justifications and disadvantages, there have always been different attitudes towards the derivative action.

Western countries among themselves also take differing approaches towards derivative action in practice, including its very role and the mechanisms for regulating it. These different approaches and the reasons for them may provide valuable experience and lessons for China on how to improve its own law on derivative action. This is also the aim of our comparative study.
This book is divided into six chapters.

Chapter 1 provides a general introduction to derivative action (such as its nature, justifications for and disadvantages of it, as well as its role) and briefly illustrates the countries chosen for the comparative study, as well as noting the structure of the study. This book has chosen England, the United States and Germany, as well as China, for the actual study. These three Western countries have their own characteristic features as far as derivative action is concerned and China is where the author is from. Although the countries we will study take different approaches towards derivative action, the major issues concerned are similar. This book has identified several key issues (that is, the function of derivative action, how to distinguish between shareholders' derivative action and direct action, how to strike a fair balance between corporate efficiency and protection for the company and its minority shareholders) and has studied the issues on a country-by-country basis. Moreover, since each country has its own traditions and background, which may affect its resolution of these issues, this book also discusses these varying backgrounds when necessary.

Chapter 2 studies English law. It starts with an introduction to the current English law on derivative actions, specifically, the *Foss v. Harbottle* rule and its exceptions as well as the development of this rule. The *Foss v. Harbottle* rule and its exceptions are important in modern company law to the extent that they have established several basic principles for company law, such as the proper plaintiff principle, the majority rule principle (which reflects the principle of non-interference in corporate business) and the minority shareholder's right to bring a derivative action against corporate misconduct in certain circumstances. In fact the law of derivative action is generally regarded as originating in English law.

However, due to the strict requirements for initiating a derivative action under English law and the traditionally unfavorable attitude toward the derivative action, current common law derivative action is regarded as obscure, complex and obsolete. It has not played an important role in England in the protection of the company and minority shareholders or in disciplining corporate management. Instead, the most popular remedy that is applied by minority shareholders, especially those in close companies, is the unfair prejudice remedy. The second section of this chapter discusses the unimportant role the derivative action plays in England and the relationship between the unfair prejudice remedy and the derivative action.

The third section of this chapter studies how English law distinguishes between shareholders' derivative actions and direct actions. This distinction is important since the plaintiff shareholder has to meet strict requirements if he wishes to bring a derivative action against the misconduct. Basically English law adopts the 'right' and/or 'injury' criteria in making such a distinction. Nevertheless, the substantive law on the rights of the company and on that of individual shareholders is not very clear in England. The discussion of the distinction mainly focuses on the three areas where the distinction is vague: where there is a breach of a company's constitution, where a director breaches his duties, and where a majority shareholder breaches his duties.

The fourth section of this chapter studies how English law tries to strike a balance between corporate efficiency and protection for the company and its minority shareholders. As already observed in the previous sections, under English law the balance favors corporate efficiency over minority protection. The main method in the common law derivative action for striking this balance is the strict restrictions (both substantive and procedural) established by the *Foss* rule. In addition, the court also plays an important role since the court's permission is needed in order to continue a derivative action.

The whole of the British Companies Act is currently in the process of reform. The proposed Companies Bill puts forth suggestions for a new statutory derivative action in order to facilitate derivative action. The most obvious change in the new statutory derivative action is that it will grant the court great discretion in controlling derivative actions. Nevertheless, this Bill is not intended to affect the current balance between corporate efficiency and minority protection.

Chapter 3 of this book studies American law. It is generally recognized that derivative action plays a more important role in the United States than in other countries and that the American rules governing derivative action are sophisticated and well developed in both facilitating and controlling derivative actions. This chapter starts with an introduction to the development of derivative actions in the United States, which can be divided into four stages. The development shows how the American law has adjusted to the tension between corporate efficiency and shareholder protection. The latest trend is that the balance is tilting more towards corporate efficiency.

The second section of this chapter studies the role of derivative action in the United States. Several features of the role are identified. First, it is a fact that the derivative action does play an important role in the United States. Second, it plays a less important role nowadays than it has in the past. Third, it plays a more important role in public corporations than in close corporations. We also point out that there is still an ongoing debate as to what role the derivative action should play.

The third section of this chapter discusses how American law identifies the nature of actions. The major criteria are the right/injury criteria. But American law also considers other factors, such as policies and repercussions of the action when identifying the nature of actions. Another feature of American law is that some American courts may take a more flexible approach towards the distinction between derivative action and direct action in close corporations due to the special nature of close corporations. Where the majority shareholder infringes on the interests of a close corporation, the real dispute lies among the shareholders and the real victims are the minority shareholders. As a result, some courts tend to identify a direct action rather than a derivative one where the close corporation is infringed by the majority shareholder. Of course, the basis for the special treatment may be different: the courts may apply a varied injury criterion, or take into account factors such as lack of justification for derivative action in close corporations, prevention of unjust enrichment, and so on.

The fourth section illustrates how American law strikes a balance between corporate efficiency and protection for the corporation and its minority shareholders. As mentioned, the American law is sophisticated in both controlling and facilitating derivative actions. The major limitations on the shareholder's right to bring a derivative action are found in the business judgment rule (which substantively restricts the scope of misconduct, which may give rise to a derivative action) and the demand requirement (which is a procedural requirement, but subjects the individual shareholder's right to bring a derivative action to the decision of the board or to the special litigation committee, as well as to the discretion of the court, which has the power to review this decision). In addition, there are other requirements such as the contemporaneous ownership requirement and security-for-expenses. In this section, we also take note of two other features of the American law. One is that it limits directors' financial exposure to the risk of the costs of litigation in order to protect corporate directors. The other feature is that due to the contingency fee agreement, attorneys to a great extent contribute

to the popularity of derivative action in the United States; this, however, has the side effect of precipitating the problem of abuse of derivative actions.

A discussion of German law is found in Chapter 4. German law has a background different from that of Anglo-American law. Therefore, in the first section of this chapter, we offer a brief summary of the German background, such as the existence of two types of companies (the AG that is equivalent to public companies, and the GmbH that is equivalent to private companies), the two-tier system of their corporate structures, as well as recent reforms in Germany concerning corporate governance. This section also serves as an introduction to how corporate claims are enforced under German law. Since the AG and the GmbH are regulated by different acts, the rules on how to enforce corporate claims are also different in each case. In short, minority shareholders of an AG have the statutory right to enforce corporate claims, while those of a GmbH do not have such a right. Minority shareholders of a GmbH only have a right of *actio pro socio*, which has been developed through case law and is not regarded as being equivalent to derivative action.

The minority shareholders' right to enforce corporate claims, which is now translated as a right to bring a derivative action according to the UMAG, has not played an important role in German corporate governance. Traditionally, German law has focused on a structural system of checks and balances rather than on liability rules for the disciplining of corporate management. The second section of this chapter also seeks to illustrate how the German rules have been working.

The third section studies how German law distinguishes the shareholders' derivative action (a corporate action before the UMAG) from a direct action. In this regard, German law strictly applies the right/injury criteria. For example, only a corporate action or a derivative action is allowed to seek a claim for damages where the company has suffered losses. This, however, may not provide sufficient protection for minority shareholders, especially in a GmbH where no derivative action is allowed, in cases where the wrongdoer is a majority shareholder of the company. The discussion of this distinction mainly focuses on those three areas: where a defective resolution of a corporate body needs to be set aside, where a director breaches his duties, and where a majority shareholder breaches his duties.

The German rules concerning how a balance is struck between corporate efficiency and protection for the company and its minority shareholders have been changed since the UMAG. The fourth section of the chapter therefore discusses both the old and the new rules in order to trace the development of German law. Under the old law, the major restriction on the minority shareholders' right to enforce corporate claims was the high capital threshold. Actually, though, there were two different capital thresholds. If the minority shareholders chose the lower one, they still found themselves subject to other restrictions. For example, they were required to show the existence of facts which justified the urgent suspicion that there was dishonesty or gross violation of law or the articles. But then they only were granted the right to cause the court to

appoint a special representative who would, in turn, have the discretion to decide whether to initiate a corporate action. The UMAG makes some fundamental changes to this situation. First, the UMAG significantly reduces the capital threshold for bringing a derivative action to that of aggregately holding one percent of the capital stock or stock with an exchange or market value of EUR 100,000. Second, the UMAG introduced the business judgment rule while restricting the scope of misconduct that might give rise to a derivative action to cases of fraud or other gross infringement of the law or of the memorandum and articles, and this in order to protect corporate management. Third, the UMAG has adopted a two-stage court procedure in order to prevent the abuse of derivative action. The procedure grants the court the discretion to decide whether to allow a derivative action. Fourth, the minority shareholders can enforce corporate claims in their own names, which means that a derivative action in a real sense is now allowed. Fifth, the UMAG has also changed the rule concerning allocation of litigation costs so that the minority shareholders may now have more incentive to bring a derivative action. In sum, these changes point to a trend where German law is becoming more lenient towards the minority shareholders' derivative action and is moving towards the Anglo-American approach.

Chapter 5 studies Chinese law. The first section discusses the background to Chinese law and the development of derivative action in China. A discussion of the background, such as the history of Chinese company law, the characteristics of regulations on corporate governance, the major agency problems found in Chinese companies and the situation for minority shareholders, can help us to form a better understanding of the Chinese law in this regard. The development of derivative actions in China is also worth noting. Chinese courts had already heard derivative actions before there was any statutory rule regarding them in the Company Act, this in spite of the fact that China has a civil law tradition. In fact, Chinese courts, especially the Supreme People's Court, have played an important role in the development of derivative actions.

The second section of this chapter discusses the function derivative action has in China. Derivative action only played a limited role before its specific introduction in Company Law 2006 because of its 'unofficial' status. However, whether it will play an important role after this introduction still remains to be seen. On the one hand, derivative action is needed in order to protect the company and minority shareholders and to discipline corporate management. On the other hand, Chinese special circumstances, such as the poor quality of its courts, the unfavorable attitude towards derivative actions in stock companies, as well as high litigation costs, may impede the application of derivative actions, especially in stock companies. Furthermore, the defects in the Chinese Company Law, such as a lack of the principle of non-interference in corporate management, may also cause problems if the derivative action is widely applied. Nevertheless, we also note that derivative action may play a more important role in Chinese limited liability companies than in stock companies.

The third section discusses how derivative action is distinguished from direct action under Chinese law. Under Chinese law, an individual shareholder can bring a direct action to nullify and withdraw a void or voidable resolution of the shareholders' meeting or of the board of directors, no matter whether the individual shareholder's rights and/or interests have been injured or not. Therefore, in such cases, a distinction is not necessary. This, however, may result in the problem of unjust interference in corporate management. On the other hand, an individual shareholder can bring a direct action to claim for damages only when his personal interests have been infringed. As a result, as far as the claim for damages is concerned, Chinese law also applies the right/injury criteria. However, Chinese law has additional problems, such as the lack of clarity in the substantive law of shareholder's rights and the fact that some rights are not coupled with remedies.

The Chinese methods for striking a balance between corporate efficiency and protection for the company and its minority shareholders are then discussed in the fourth section. The importance of striking a balance has also been recognized in China and Chinese law has already taken some measures for achieving this. However, these major methods entail procedural restrictions on the minority shareholders' right to bring a derivative action, such as the standing requirement for shareholders in stock companies and the demand requirement. The principle of non-judicial interference in corporate management has not been well acknowledged and there have been no restrictions such as the American business judgment rule to protect directors from liability for their mere negligence. Under what circumstances a controlling shareholder will be held liable is also unclear. Furthermore, the high litigation costs, which are born by the plaintiff shareholders, will negatively affect their incentive to pursue a derivative action. All these problems show that Chinese law still needs to be improved in order to strike a balance.

The last chapter of this book offers our conclusions. On each issue we first draw conclusions from the comparative study and then make suggestions for China. As far as the function of derivative action is concerned, we conclude that (1) derivative actions play different roles in all these countries; (2) their function may vary according to the agency problems to be solved and the type and size of the companies involved; and (3) derivative action is only one method in a comprehensive system of corporate governance. Recognizing that derivative action does and will continue to play a more important role in Chinese limited liability companies than in stock companies, we suggest that China improve the function of derivative action in stock companies and at the same time develop other mechanisms to provide better protection for minority shareholders.

As far as this distinction is concerned, we conclude that the injury and/or right criteria are widely applied. However, the distinction is not always clear, especially in the case of owner-managed companies. Chinese law also adopts the injury and/or right criteria but has defects such as the fact that the substantive law on the rights of the minority shareholders and of the company is vague, while some

rights of minority shareholders are not coupled with remedies, and corporate management may be unjustly interfered with. Reform of these defects should be undertaken.

Comparative study shows that the issue of how to strike a balance between corporate efficiency and protection for the company and its minority shareholders is key in derivative actions. It is also a comprehensive task. After studying the rules in Western countries, we have suggested that China should improve its law overall instead of in one single aspect. Such improvements would entail identifying the appropriate body for making a corporate litigation decision, introducing the business judgment rule, solving the plaintiff's incentive problem, as well as improving the demand requirement.

Samenvatting

Wanneer schade is toegebracht aan een vennootschap heeft als uitgangspunt te gelden dat de procedure tegen de veroorzaker van de schade door de vennootschap moet worden gevoerd en dat eventuele schadevergoeding aan de vennootschap moet worden betaald. Onder bepaalde omstandigheden (zoals bijvoorbeeld in het geval dat de vennootschap wordt beheerst door de veroorzaker van de schade en daardoor zelf geen procedure kan beginnen) echter kan een aandeelhouder of een groep van minderheidsaandeelhouders van de desbetreffende vennootschap op eigen naam een *derivative action*[1] beginnen om de belangen van de vennootschap en haar aandeelhouders te beschermen. Deze uitzondering op het beginsel dat de vennootschap zelf schadevergoeding eist brengt nadelen met zich mee. Er bestaat risico op onterechte inmenging in het management van de vennootschap en de aandeelhouders zijn niet altijd voldoende gemotiveerd om een procedure te beginnen. Gezien de voors en tegens van *derivative action* bestaan hierover uiteenlopende meningen.

Westerse landen hanteren bovendien in de praktijk een verschillende benadering van *derivative action*, zowel ten aanzien van de functie als de wettelijke regeling ervan. Deze verschillen in benadering en de redenen voor die verschillen kunnen waardevolle inzichten opleveren, die kunnen bijdragen tot verbetering van de Chinese derivative *action*-wetgeving. Het rechtsvergelijkende onderzoek in dit boek richt zich daarom op deze inzichten.
Het boek bestaat uit zes hoofdstukken.

Hoofdstuk 1 geeft een algemene introductie van het begrip *derivative action*. Het benoemt de kenmerken van *derivative action*, de voors en de tegens en geeft een korte beschrijving van de landen die zijn gekozen als object van het rechtsvergelijkende onderzoek. Tevens wordt de opzet van het onderzoek uiteengezet. In dit onderzoek is ervoor gekozen om Engeland, de Verenigde Staten, Duitsland en China te bestuderen. De drie westerse landen hebben hun eigen specifieke kenmerken met betrekking tot *derivative action*, en China is het geboorteland van de auteur. De benadering van *derivative action* door deze landen is verschillend, maar de belangrijkste aspecten zijn hetzelfde. Het boek identificeert een aantal essentiële kernthema's: de functie van *derivative action*, hoe een *derivative action*

1 In Nederland bestaat de 'afgeleide actie' zoals hier besproken wordt als zodanig niet, derhalve is er voor gekozen de term *derivative action* te blijven gebruiken.

ingesteld door aandeelhouders kan worden onderscheiden van een rechtstreekse vordering, hoe het evenwicht kan worden gevonden tussen *corporate efficiency* en de bescherming van het bedrijf en zijn minderheidsaandeelhouders. Deze thema's worden per land besproken. Als bepaalde tradities en de specifieke achtergrond van landen de benadering van deze kwesties kunnen beïnvloeden, besteedt het boek daar ook aandacht aan.

In hoofdstuk 2 wordt het Engelse recht nader bekeken. Het hoofdstuk begint met een introductie van het geldende Engelse recht op het gebied van *derivative action*, en bespreekt in het bijzonder de *Foss v. Harbottle rule*, de uitzonderingen daarop en de ontwikkeling ervan. Deze *rule* en de uitzonderingen erop zijn belangrijk voor het huidige vennootschapsrecht. In deze beslissing werd een aantal basisprincipes van het vennootschapsrecht vastgesteld, zoals het *proper plaintiff principle*, het principe van de *majority rule* – dit drukt het uitgangspunt van geen inmenging in *corporate management* uit – en het recht van minderheidsaandeelhouders om, onder bepaalde omstandigheden, een *derivative action* in te stellen indien er sprake is van wanbeleid. Overigens wordt over het algemeen van de *derivative action* aangenomen dat zij is ontstaan in het Engelse recht.

Het geldende recht met betrekking tot *derivative action* wordt beschouwd als een obscuur, ingewikkeld en achterhaald rechtsgebied vanwege de strenge voorwaarden die worden gesteld aan de eisende partij en de van oudsher negatieve houding ten aanzien van *derivative action*. *Derivative action* heeft dan ook geen belangrijke rol gespeeld in Engeland bij het beschermen van vennootschappen en hun minderheidsaandeelhouders noch bij het toezicht houden op het management. In plaats daarvan is de meest populaire oplossing voor minderheidsaandeelhouders, met name die in *close companies*, de vordering op grond van *unfair prejudice*. In het tweede gedeelte van dit hoofdstuk wordt deze ondergeschikte rol van *derivative action* en het verband tussen *derivative action* en de gangbare oplossing van *unfair prejudice* nader bezien.

In het derde gedeelte van dit hoofdstuk wordt onderzocht op welke wijze het Engelse recht een *derivative action* van minderheidsaandeelhouders onderscheidt van een rechtstreekse vordering. Het verschil is belangrijk omdat de eisende aandeelhouder(s) die een *derivative action* wil instellen tegen wangedrag aan strenge voorwaarden moet(en) voldoen. Het Engelse recht maakt hier gebruik van twee criteria om het onderscheid te duiden: het criterium van *right* (recht) en/of *injury* (schade/nadeel). Desondanks is het materiële recht in Engeland met betrekking tot de rechten van de vennootschap en de rechten van haar individuele aandeelhouders onduidelijk. De discussie richt zich voornamelijk op de drie gebieden waar het onderscheid niet helder is, namelijk schending van bepalingen in de statuten, *breach of duty* door een bestuurder en *breach of duty* door een meerderheidsaandeelhouder.

In het vierde gedeelte van hoofdstuk 2 wordt bekeken hoe het Engelse recht het evenwicht probeert te vinden tussen *corporate efficiency* en bescherming voor het bedrijf en minderheidsaandeelhouders. Zoals al eerder opgemerkt in voorgaande alinea's slaat in het Engelse recht de balans door naar *corporate efficien-*

cy ten koste van de bescherming van minderheidsbelangen. De belangrijkste wijze waarop in de op *common law* gebaseerde *derivative action* het evenwicht wordt gevonden bestaat uit de strenge (materiële en procedurele) eisen die met de *Foss rule* zijn vastgesteld. Daarbij komt dat de rechter een belangrijke rol heeft, aangezien deze toestemming moet geven voordat een *derivative action* kan worden voortgezet.

De Engelse *Companies Act* wordt momenteel in zijn geheel herzien. Het wetsvoorstel, de *Companies Bill*, komt met een nieuwe regeling om *derivative action* te vergemakkelijken. De meest in het oog springende verandering in dit nieuwe voorstel is de ruime discretionaire bevoegdheid die aan de rechter wordt toegekend als het gaat om het al dan niet toelaten van een *derivative action*. Het wetsvoorstel is echter niet bedoeld om de huidige balans tussen *corporate efficiency* en minderheidsbelangen te veranderen.

Hoofdstuk 3 betreft het Amerikaanse recht. Over het algemeen wordt erkend dat *derivative action* een belangrijkere rol speelt in de Verenigde Staten dan in andere landen en dat de Amerikaanse *derivative action*-wetgeving verfijnde en goed ontwikkelde regels bevat, die enerzijds de *derivative action* faciliteren en anderzijds uitwassen beogen te voorkomen. Het hoofdstuk begint met een introductie van de ontwikkeling van *derivative action* in de Verenigde Staten. Deze ontwikkeling kan worden ingedeeld in vier fasen en laat zien hoe het Amerikaanse recht het evenwicht heeft gevonden tussen *corporate efficiency* en de bescherming van de aandeelhouders. Recentelijk begint de balans door te slaan naar *efficiency*.
In het tweede gedeelte van dit hoofdstuk wordt de rol van *derivative action* in de VS onderzocht en wordt een aantal kenmerken van deze rol vastgesteld. Ten eerste is het duidelijk dat de *derivative action* in de VS een belangrijke rol vervult. Ten tweede is die rol tegenwoordig minder groot dan in het verleden. Ten derde is *derivative action* belangrijker voor *public corporations* dan voor *close corporations*. Overigens woeden er in de VS nog steeds discussies over wat de functie van *derivative action* zou moeten zijn.

In het derde gedeelte van hoofdstuk 3 bekijken we hoe Amerikaans recht onderscheid maakt tussen verschillende vorderingen. De belangrijkste criteria zijn die van *right/injury*, maar er wordt ook gelet op andere factoren, zoals beleidsoverwegingen en repercussies van een actie, om het onderscheid vast te stellen. Een ander kenmerk van Amerikaans recht is de flexibele benadering die Amerikaanse rechters soms hanteren als het gaat om het verschil tussen een *derivative action* en een rechtstreekse vordering in geval van *close companies*. Deze benadering komt voort uit het bijzondere karakter van *close companies*. Bij schending van de belangen van een *close corporation* door een meerderheidsaandeelhouder speelt het conflict zich in feite af tussen de aandeelhouders. Het werkelijke slachtoffer is niet de vennootschap, maar de minderheidsaandeelhouders. Het resultaat is dat in dergelijke gevallen nogal eens wordt uitgegaan van een rechtstreekse vordering in plaats van een *derivative action*. De grondslag voor deze speciale benadering kan van geval tot geval verschillen. Soms past de rechter een ruim *injury*-criterium toe, of worden factoren als de onmogelijkheid van een *derivative action*

in geval van een *close corporation* of het voorkomen van ongerechtvaardigde verrijking in aanmerking genomen.

Het vierde gedeelte schetst het evenwicht dat het Amerikaanse recht heeft gevonden tussen *corporate efficiency* en de bescherming van de vennootschap en haar minderheidsaandeelhouders. Zoals eerder aangestipt bevat de Amerikaanse *derivative action* wetgeving verfijnde regels zowel ter facilitering als ter voorkoming van misbruik van *derivative actions*. De voornaamste beperkingen van het recht om een *derivative action* in te stellen zijn de *business judgment rule* (deze begrenst het begrip 'slecht management' dat de grondslag vormt voor een dergelijke vordering) en de *demand requirement* (dit is een procedurele voorwaarde die het recht van een aandeelhouder om een *derivative action* te beginnen onderwerpt aan het besluit van het management of de beslissing van de speciale procescommissie). Bovendien heeft de rechter vervolgens de bevoegdheid deze beslissing te herzien. Overige voorwaarden zijn *contemporaneous ownership* en *security-for-expenses*. In dit vierde deel worden nog twee andere kenmerken van het Amerikaanse recht gesignaleerd. Ten eerste beschermt het Amerikaanse recht bestuurders door het risico dat de bestuurder wordt veroordeeld in de proceskosten te beperken. Ten tweede is de populariteit van de *derivative action* voor een belangrijk deel toe te schrijven aan de advocatuur, die in de VS op *no cure, no pay*-basis mag werken. De consequentie van deze populariteit is echter dat er nog wel eens misbruik wordt gemaakt van de mogelijkheid om een *derivative action* in te stellen.

In hoofdstuk 4 wordt aandacht besteed aan het Duitse recht, dat een andere achtergrond heeft dan het Anglo-Amerikaanse recht. Daarom wordt in het eerste gedeelte van dit hoofdstuk eerst deze achtergrond belicht. Achtereenvolgens wordt stilgestaan bij: het onderscheid tussen de twee Duitse kapitaalvennootschappen (De AG, die overeenkomt met de NV, en de GmbH die correspondeert met de BV), de two-tier bestuursstructuur in deze vennootschappen en recente Duitse wetswijzigingen op het terrein van *corporate governance*. Dit deel bevat tevens inleidende opmerkingen over de wijze waarop rechtsvorderingen van de vennootschap naar Duits recht geldend gemaakt kunnen worden. De regeling van de AG en de GmbH wordt in twee afzonderlijke wetten uitgewerkt en er zijn dan ook verschillende regels met betrekking tot het instellen van vorderingen ten behoeve van de vennootschap. Het komt erop neer dat de minderheidsaandeelhouders van een AG een wettelijk erkend recht hebben een vordering namens de vennootschap in te dienen; de minderheidsaandeelhouders van een GmbH hebben dat recht niet. De laatsten kunnen enkel een *actio pro socio* beginnen. Deze *actio* is het product van jurisprudentie en wordt niet beschouwd als gelijkwaardig aan een *derivative action*.

Het recht van minderheidsaandeelhouders om een vordering van de vennootschap geldend te maken, een recht dat inmiddels volgens het UMAG (Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts) inhoudt dat aandeelhouders een *derivative action* kunnen instellen, heeft binnen het Duitse systeem van Duitse *corporate governance* geen belangrijke rol gespeeld . Het

Duitse recht legt van oudsher de nadruk op een gestructureerd systeem van *checks and balances*, in plaats van op aansprakelijkheidsregels als middel om het bestuur van de vennootschap ter verantwoording te roepen. In het tweede deel van het hoofdstuk wordt geïllustreerd hoe de Duitse corporate governance-regels tot dusverre hebben gefunctioneerd.

In het derde deel zien we hoe het Duitse recht onderscheid maakt tussen een *derivative action* van aandeelhouders (vóór invoering van het UMAG: een vordering van de vennootschap) en een rechtstreekse vordering. In Duitsland wordt streng de hand gehouden aan de *right/injury* criteria. Indien de vennootschap schade heeft geleden is slechts een vordering ingesteld door de vennootschap of een *derivative action* mogelijk. Dit uitgangspunt betekent dat de minderheidsaandeelhouders soms onvoldoende worden beschermd als de boosdoener een meerderheidsaandeelhouder is. Dit zal zich met name kunnen voordoen bij een GmbH, aangezien haar aandeelhouders niet beschikken over een *derivative action*. De behandeling van het verschil richt zich met name op de volgende drie situaties: ten eerste de situatie waarin een vernietigbaar besluit van een vennootschappelijk orgaan moet worden vernietigd, ten tweede de situatie van *breach of duty* door een bestuurder, en ten derde *breach of duty* door een meerderheidsaandeelhouder.

Ten gevolge van de invoering van het UMAG zijn de Duitse regels met betrekking tot het evenwicht tussen *corporate efficiency* en de bescherming van de vennootschap en de minderheidsaandeelhouders gewijzigd. In het vierde gedeelte van hoofdstuk 4 worden de oude en de recente wetgeving in Duitsland nader onderzocht om zo de ontwikkeling van het Duitse recht te kunnen weergeven. De belangrijkste beperking van het vorderingsrecht van minderheidsaandeelhouders onder de oude wetgeving betrof het kapitaalvereiste. Om precies te zijn bestonden er zelfs twee verschillende kapitaaldrempels. Als de aandeelhouders kozen voor de lage kapitaaldrempel kregen ze te maken met andere beperkingen. Zo moest men dan feiten aandragen ter rechtvaardiging van een ernstig vermoeden dat er sprake was van oneerlijkheid of grove overtreding van wetgeving of de statuten. Daarbij kwam dat de minderheidsaandeelhouders in zo'n geval enkel de rechtbank konden vragen een speciale vertegenwoordiger aan te stellen die de bevoegdheid had om te besluiten tot het instellen van een vordering namens de vennootschap. Het UMAG heeft hierin grote veranderingen gebracht. Ten eerste is de kapitaaldrempel voor een *derivative action* significant verlaagd tot aandeelhouders die gezamenlijk 1% van het maatschappelijk kapitaal bezitten, of aandelen met een beurs- dan wel marktwaarde van 100.000 euro. Ten tweede introduceert het UMAG de *business judgment rule*, waarbij – om de bestuurders van vennootschappen te beschermen – de mogelijkheid van een *derivative action* tegen onbehoorlijk bestuur wordt beperkt tot gevallen van fraude en/of grove schending van de wet of de statuten. Ten derde voert het UMAG een procedure in twee fasen in om te voorkomen dat er misbruik wordt gemaakt van *derivative action*. In de eerste fase van deze procedure hebben rechters de bevoegdheid te beslissen over de voortzetting van een *derivative action*. Ten vierde kunnen de minderheidsaandeelhouders een vordering van de vennootschap op eigen naam geldend maken,

wat betekent dat nu een echte *derivative action* mogelijk is. Punt vijf is dat wetgeving met betrekking tot de veroordeling in proceskosten is veranderd waardoor minderheidsaandeelhouders eerder geneigd zullen zijn tot het instellen van een *derivative action*. Kort gezegd wijzen deze veranderingen op een meer welwillende houding van de Duitse wetgever ten opzichte van de *derivative action* door minderheidsaandeelhouders, waardoor het Duitse recht opschuift in de richting van deAnglo-Amerikaanse benadering.

In hoofdstuk 5 wordt het Chinese recht onder de loep genomen. In het eerste geeelte van het hoofdstuk wordt gekeken naar de achtergronden van het Chinese recht en de geschiedenis van *derivative action* in China. Een bespreking van deze achtergronden, zoals de geschiedenis van het Chinese vennootschapsrecht, de kenmerken van *corporate governance*-wetgeving, de grote principaal-agent-problemen in Chinese bedrijven en de situatie van minderheidsaandeelhouders, kan bijdragen aan een beter begrip van het Chinese recht. Het is ook van belang om de ontwikkeling van *derivative action* in China nader te bekijken. Chinese rechtbanken hadden *derivative action* al toegestaan, ook zonder dat hieraan enige wettelijke regeling ten grondslag lag, en ondanks het feit dat het Chinese recht gebaseerd is op de *civil law* traditie van gecodificeerd recht. Chinese rechters, en met name de rechters van de *Supreme People's Court*, hebben zelfs een belangrijke rol gespeeld bij de ontwikkeling van *derivative action*.

In het tweede gedeelte van dit hoofdstuk wordt gekeken naar de rol van *derivative action* in China. *Derivative action* werd officieel geïntroduceerd in de Company Law 2006; voorheen was het van weinig betekenis. Het valt nog te bezien of met deze invoering een verandering is ingezet. Enerzijds is *derivative action* is aan de ene kant noodzakelijk om vennootschappen en hun minderheidsaandeelhouders te beschermen en als middel om het management van de vennootschap ter verantwoording te roepen. Anderzijds kunnen specifieke Chinese omstandigheden, zoals het gebrek aan inhoudelijke kwaliteit bij de rechtbanken, de afwijzende houding ten aanzien van *derivative action* met betrekking tot *stock companies* (het Chinese equivalent van naamloze vennootschappen) en de hoge proceskosten het gebruik van *derivative action* belemmeren, met name als het gaat om stock companies vennootschappen. Ook kent de *Chinese Company Law* tekortkomingen (bijvoorbeeld het ontbreken van het beginsel van geen inmenging in *corporate management*) die tot problemen kunnen leiden als *derivative action* op grote schaal zou worden toegepast. Desondanks plaatsen hier we de opmerking dat *derivative action* wellicht een grotere rol zou kunnen spelen voor *limited liability companies* (Chinese BV's) dan voor *stock companies*.

Deel drie behandelt het onderscheid dat het Chinese recht maakt tussen *derivative action* en een rechtstreekse vordering. Het is toegestaan dat een aandeelhouder een nietigverklaring vordert van een nietig (of vernietiging vordert van een vernietigbaar) besluit van de aandeelhoudersvergadering of de Raad van Bestuur, ongeacht of de rechten of belangen van deze aandeelhouder zijn geschonden. In dergelijke gevallen is het onderscheid derhalve niet relevant, maar het brengt wel het probleem van onterechte inmenging in *corporate management*

met zich mee. Een aandeelhouder kan echter enkel een rechtstreekse vordering tot schadevergoeding instellen als zijn persoonlijke belangen zijn geschonden. Dit betekent, dat ook het Chinese recht, althans voor zover het vorderingen tot schadevergoeding betreft, gebruik maakt van het *right/injury*-criterium. Bijkomende problemen in het Chinese recht zijn echter het gebrek aan duidelijkheid van het materiële recht ten aanzien van aandeelhoudersrechten en het feit dat bepaalde rechten niet geldend kunnen worden gemaakt omdat een rechtsgang ontbreekt.

De wijze waarop in China het evenwicht wordt gezocht tussen *corporate efficiency* en bescherming van de vennootschap en de minderheidsaandeelhouders komt aan de orde in deel vier. Het belang van evenwicht tussen deze twee wordt erkend en de Chinese wetgever heeft een aantal stappen ondernomen om een evenwicht te creëren. De belangrijkste daarvan zijn procedurele beperkingen van het recht van minderheidsaandeelhouders om een *derivative action* in te stellen. Zo is er een *standing requirement* ingevoerd voor aandeelhouders in vennootschappen en de *demand requirement* is tevens ingevoerd. Het beginsel van geen inmenging in *corporate management* is echter niet algemeen geaccepteerd en er bestaan geen beperkingen zoals de Amerikaanse *business judgment rule* die bestuurders beschermt tegen vorderingen tot schadevergoeding op grond van enkel nalatigheid. Ook zijn de omstandigheden waaronder een aandeelhouder met beslissende invloed aansprakelijk kan worden gesteld niet helder. Daarbij komt dat de hoge proceskosten die moeten worden voldaan door de eisende aandeelhouders hen niet zal stimuleren tot het instellen van een *derivative action*. Deze problemen tonen aan dat de Chinese wetgeving verdere verbetering behoeft teneinde een goed evenwicht te vinden.

Het laatste hoofdstuk van het boek bevat de conclusies van het onderzoek. Per onderwerp komen eerst de conclusies van het vergelijkende onderzoek aan bod, waarna voorstellen volgen tot verbetering van het Chinese recht. Wat de rol van *derivative action* betreft, zijn onze bevindingen dat (1) *derivative action* verschillende functies heeft in de besproken landen; (2) deze functie afhankelijk is van de principaal-agent-problemen die opgelost moeten worden en tevens van de ondernemingsvorm en haar omvang; (3) *derivative action* vormt enkel een onderdeel van het geheel van regels met betrekking tot *corporate governance*. Hoewel *derivative action* een belangrijkere rol zal blijven spelen voor aandeelhouders van *limited liability companies* dan voor aandeelhouders van *stock companies*, zou China er toch goed aan doen de rol van *derivative action* te verbeteren ten aanzien van *stock companies* en tevens andere instrumenten in te voeren met het oog op een betere bescherming van minderheidsaandeelhouders.

Wat betreft het onderscheid tussen *derivative action* en een rechtstreekse vordering is onze conclusie dat het *injury/right*-criterium breed wordt toegepast. Desondanks is het onderscheid niet altijd duidelijk, met name niet in geval van vennootschappen die worden bestuurd door de aandeelhouder. Het *injury/right*-criterium is overgenomen in het Chinese recht, maar brengt problemen met zich mee. In China ontbreekt het aan materieel recht dat de rechten van minderheidsaandeelhouders en de vennootschap regelt, en soms bestaat er geen rechtsgang, al

zijn er wel rechten toegekend aan minderheidsaandeelhouders. Bovendien bestaat er een risico op onterechte inmenging in *corporate management*. Aan deze tekortkomingen zal moeten worden gewerkt.

Ons vergelijkend onderzoek toont aan dat de sleutel van een goede regeling van *derivative action* ligt in het vinden van evenwicht tussen *corporate efficiency* en de bescherming van de vennootschap en haar minderheidsaandeelhouders. Dit is een complexe taak. Gezien onze bevindingen met betrekking tot de regelgeving in Westerse landen stellen wij voor dat China de regels met betrekking tot *derivative action* niet op één specifiek punt verbetert, maar deze in hun geheel hervormt. Verbeteringen die in dit onderzoek worden voorgesteld zijn: de aanwijzing van het orgaan dat bevoegd is om te beslissen tot het instellen van een corporate claim, de invoering van de *business judgment rule*, het oplossen van het probleem dat een stimulans voor aandeelhouders om tot *derivative action* over te gaan ontbreekt en het verbeteren van de *demand requirement*.

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