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The derivative action: an economic, historical and practice-oriented approach

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I Introduction

The derivative action, also known as the derivative suit (in the United States), *Aktionärsklage* (Germany), *kabunushi daihyō soshō* (Japan), *action sociale ut singuli* (France) and *paisheng susong* (PRC) (among others),[1] is a global phenomenon. It originated in the common law world[2] and is regarded by some as 'one of the most interesting and ingenious . . . accountability mechanisms for large formal organizations'.[3] As a potentially powerful elixir for corporate governance ills, the derivative action has captivated lawmakers for well over a century. It is also a subject that has long intrigued academics – and rightfully so. The beauty of the derivative action is truly in the eye of the beholder, making it ripe for scholarly debate. Depending on one's vantage point, it can be seen as either a functional necessity for meaningfully enforcing directors' duties, which mitigates agency costs, or a corporate governance mechanism inherently vexed by a litany of complex procedural problems, which stifles entrepreneurship. We suspect that, after reading this book, you will conclude that the truth about the derivative action in Asia lies somewhere in between these two extremes.

Few, if any, legislatures or courts have been able to strike the appropriate balance between the necessary incentives to ensure that derivative actions are pursued effectively and the indispensable safeguards to prevent their abuse (what we term in this book the 'Holy Grail' of derivative actions regulation). Ironically, in spite of generations of

[1] The term is explained in greater detail infra at section II, 1.
[2] See infra at sections III, 1, 2.
[3] Quoted after the classic treatise by R. Clark, *Corporate Law* (1986), Boston: Little, Brown, 639.

legislative craftsmanship and academic musings, in almost all jurisdictions derivative actions are rare. Even in the United States[4] and Japan,[5] where derivative actions occur idiosyncratically with some regularity, their popularity has substantially fluctuated over time. Nevertheless, or perhaps because of this, a number of key jurisdictions – including Singapore (1993),[6] New Zealand (1994),[7] Italy (1998),[8] Australia (2000),[9] Hong Kong (2005),[10] Germany (2005),[11] the United Kingdom (2006)[12] and the People's Republic of China (2006)[13]– have recently introduced statutory (codified) derivative actions with the hope of transplanting the 'Holy Grail' into their corporate governance regimes. Other jurisdictions, including Japan (1993),[14] South Korea (1998)[15] and Taiwan (2010),[16] have attempted to uncover the Holy Grail more cautiously by tinkering with their existing derivative actions legislation – sometimes with unforeseen and dramatic results.[17]

Given this diverse background, it comes as no surprise that the derivative action has increasingly piqued the interest of comparative corporate lawyers and scholars. Besides various country-specific analyses,[18] a couple of bilateral and multilateral studies have been published in recent

[4] Infra at sections III, 1; IV, 1. [5] Infra at Chapter 3. [6] Infra at Chapter 8.
[7] M. Berkahn, 'The derivative action in Australia and New Zealand: will the statutory provisions improve shareholders' enforcement rights?' (1998), *Bond Law Review* 10, 1: 74–100.
[8] See the critical analysis by P. Giudici, 'Representative litigation in Italian capital markets: Italian derivative suits and (if ever) securities class actions' (2009), *European Company and Financial Law Review* 6, 2/3: 246–69: '[The derivative action introduced in 1998] can be considered up to now an abject failure' (246).
[9] I. Ramsay and B. Saunders, 'Litigation by shareholders and directors: an empirical study of the statutory derivative action' (2006), *Journal of Corporate Law Studies* 6, 2: 397–446.
[10] Infra at Chapter 7. [11] Infra at sections III, 3; IV, 4.
[12] Infra at sections III, 2; IV, 2. [13] Infra at Chapter 6. [14] Infra at Chapter 3.
[15] Infra at Chapter 4. [16] Infra at Chapter 5.
[17] For instance, as shown in an example in Chapter 3, a small legislative change in 1993 in Japan has been credited with transforming it from a jurisdiction almost devoid of derivative litigation to a jurisdiction that competes with Delaware for the largest number of derivative actions involving listed companies.
[18] See, for example, the monographs by A. Reisberg, *Derivative Actions and Corporate Governance* (2007), Oxford University Press – with an emphasis on regulation in the United Kingdom; D. DeMott, *Shareholder Derivative Actions: Law and Practice* (1990), Deerfield, IL.: Clark, Boardman, Callaghan – on US regulation; A. Winnen, *Die Innenhaftung des Vorstandes nach dem UMAG* [*Directors' Liability with respect to the Company under the UMAG*] (2009), Baden-Baden: Nomos – an introduction to the new German regulation; J.-C. Pagnucco, *L'action sociale ut singuli et ut universi en droit des groupements* [*The Derivative Action and the Regulation of Groups of Companies*] (2006), Paris: L.G.D.J. – regulation in France; H. Kobayashi and M. Kondō (eds.), *Atarashii*

years that either focus directly on derivative actions or discuss them in the context of the (private) enforcement of shareholder rights.[19] However, these analyses deal almost exclusively with the US and European jurisdictions. As a general rule, apart from an occasional reference to China or Japan, Asian jurisdictions are not included in these comparative analyses. In this book we aim to close this gap in the literature

kabunushi daihyō soshō [*The New Shareholders' Derivative Action*] (2003), Tokyo: Kōbundō – new developments in Japan; and O. Kliesow, *Aktionärsrechte und Aktionärsklage in Japan* [*Shareholder Rights and Derivative Action in Japan*] (2001), Tübingen: Mohr Siebeck.

19 See, for example, M. Siems, 'Private enforcement of directors' duties: derivative actions as a global phenomenon', Working Paper no. 2010-MS-1 (2010), University of East Anglia Law School, Norwich (available at www.uea.ac.uk/law/Research/Papers) – dealing, briefly, with the United States, Japan, France, the United Kingdom, China and Germany {an earlier version is 'Welche Auswirkungen hat das neue Verfolgungsrecht der Aktionärsminderheit?' ['What are the consequences of the new right for bringing actions granted to minority shareholders?'] (2005), *Zeitschrift für Vergleichende Rechtswissenschaft* 104, 3: 376–94 – dealing with Germany and, briefly, with the United States, Japan, France and Italy}; a special issue of *European Company and Financial Law Review* (2009), 6, 2/3 – dealing with shareholder suits in the United States and various European jurisdictions; J. Armour, B. Black, B. Cheffins and R. Nolan, 'Private enforcement of corporate law: an empirical comparison of the UK and US' (2009), *Journal of Empirical Legal Studies* 6, 4: 687–722; X. Li, *A Comparative Study of Shareholders' Derivative Actions: England, the United States, Germany and China* (2007), Deventer: Kluwer; D. Latella, *L'azione sociale di responsabilità esercitata dalla minoranza* [*Derivative Action and Minority Protection*] (2007), Turin: Giappichelli – dealing with the pertinent regulation in Italy, the United States, France, Spain and Germany; B. Cheffins and B. Black, 'Outside director liability across countries' (2005), *Texas Law Review* 84, 6: 1385–480 – covering the United Kingdom and Germany, as well as (more briefly) Australia, Canada, France and Japan (the discussion includes a brief analysis of the respective legal regimes on derivative actions); S. Kalss (ed.), *Vorstandshaftung in 15 europäischen Ländern* [*Director Liability in 15 European Countries*] (2005), Vienna: Linde – covering Austria, Germany, the United Kingdom, France, Italy, the Netherlands, Spain, Sweden and Switzerland, as well as Poland and other eastern European jurisdictions; H. Hirt, *The Enforcement of Directors' Duties in Britain and Germany* (2004), Oxford: Peter Lang; A. van Aaken, 'Shareholder suits as a technique of internalization and control of management' (2004), *Rabels Zeitschrift für ausländisches und internationales Privatrecht* 68, 2: 288–327 – discussing US and German regulation from the perspective of institutional economics; F. Rollin, *Die Aktionärsklage in England und Deutschland* [*Derivative Actions in the United Kingdom and Germany*] (2001), Baden-Baden: Nomos; M. Becker, *Verwaltungskontrolle durch Gesellschafterrechte* [*Control of Management by Shareholder Rights*] (1997), Tübingen: Mohr Siebeck – comparing US and German regulation; and M. Planck, *Aktionärsklagen im französischen und deutschen Recht unter Einbeziehung der neueren Rechtsentwicklung in Belgien* [*Derivative Actions in French and German Law including Recent Developments in Belgian Law*] (1995), Frankfurt: Peter Lang.

by examining the derivative action in seven leading Asian jurisdictions from a comparative perspective.

This chapter provides a general theoretical framework for the book and links the ongoing international discussion about the pros and cons of the derivative action with the seven jurisdiction-specific chapters in this volume. The balance of this chapter is organized on the basis of three perspectives from which derivative actions can be analysed. It starts, in section II, by providing an *economic perspective*, which identifies the primary features and functions (including the functional deficits) of the derivative action as a mechanism for improving the efficiency of corporate governance. It then examines a striking paradox in the economic incentives that drive derivative actions: most empirical evidence suggests that derivative actions normally result in a net economic loss for the plaintiff shareholder pursuing the action (and even for the individual company involved), but they are still commonly viewed by most legislators and judges as an indispensable deterrent against reckless behaviour by directors, controlling shareholders and others who may owe a duty to the company.[20] In a similar vein, this section pays special attention to the difficulty of designing a derivative action that incentivizes shareholders to pursue derivative actions, which enhance corporate governance efficiency, while at the same time preventing their abuse (i.e., the Holy Grail).

Next, in section III, this chapter examines the derivative action from a *historical perspective*, by tracing its modern origins to the common law jurisprudence of the United States and the United Kingdom in the nineteenth century. The German historical experience is also briefly considered, so as to highlight its long history of rejecting the introduction of a US-/UK-style derivative action (until 2005), instead relying on functionally equivalent corporate governance solutions. This historical overview provides an important context for understanding the derivative action in Asia, as most leading Asian jurisdictions have transplanted some or all of the legal framework governing their derivative actions from the United States, the United Kingdom or Germany.

This chapter concludes, in section IV, by viewing the derivative action from a *practice-oriented perspective*, which focuses on how the derivative action is actually working in selected major non-Asian jurisdictions. This section includes an examination of the United Kingdom (with a

[20] See, for example, Li (*A Comparative Study*), 4; and Reisberg (*Derivative Actions*), 18f., 300f.

focus on the statutory derivative action, which was recently implemented in the Companies Act of 2006), the United States (with a focus on Delaware corporate law and the Model Business Corporations Act), France (with a focus on its role as a forerunner in derivative actions legislation in continental Europe) and Germany (with a focus on its recent introduction of a statutory derivative action that was ambitiously, but not necessarily successfully, designed to avoid the pitfalls of the US system).

Chapter 2, the *second general chapter*, focuses squarely on the derivative action in Asia. It starts by explaining the rationale for selecting the seven Asian jurisdictions covered in this book and then outlines the common methodology used in the jurisdiction-specific chapters. Next, it provides an overview of the most important findings from the seven jurisdiction-specific chapters. Finally, it examines these important findings to answer the ostensibly simple, but critically important, question of whether it makes sense to analyse the derivative action through an 'Asian lens'. In attempting to answer this question, Chapter 2 draws on three prominent Asian and comparative corporate law theories to determine whether any of them can provide a logical explanation for the evolution and practice of the derivative action in Asia.

First, it considers the often cited 'reluctant Asian litigant theory' to see whether it can provide a compelling explanation for the dearth of derivative actions in several of our Asian jurisdictions. Cleary, the facts in our Asian jurisdictions do not fit the theory. To the contrary, they turn the reluctant Asian litigant theory on its head. In addition, Chapter 2 illustrates that the more general lens of 'Asian culture' has scant explanatory or predictive value for understanding either the evolution or practice of the derivative action in Asia. In this sense, this book will disappoint those looking for more tropes or stereotypes about the *Asian* shareholder, *Asian* litigant, *Asian* judge, *Asian* regulator or any other actor or institution, which ostensibly acts in a predictable manner merely because of its geographical situs in *Asia*.

Second, Chapter 2 considers whether the findings in our seven Asian jurisdictions can be understood through the watershed legal origins theory. In addition, it considers whether one of the most important claims of the legal origins theory – that the common law is superior to the civil law for protecting minority shareholders – holds true in the context of the derivative action in Asia. Again, rather quickly, it becomes apparent that the facts in our seven Asian jurisdictions do not match the legal origins theory. Specifically, the common or civil law status of our jurisdictions has limited predictive or explanatory value in terms of how the derivative action actually functions in any given jurisdiction. Moreover, to the limited extent that a jurisdiction's legal origin matters, having a common law origin appears to be far more of a hindrance than a help for minority shareholders – which is the opposite of what the common law superiority theory suggests.

Third, Chapter 2 considers whether the economically rational shareholder theory can make sense out of the major findings in our seven Asian jurisdictions. Specifically, it examines whether shareholders in the jurisdictions normally pursue derivative actions only when the financial benefits of pursuing a derivative action are greater than the financial costs (and vice versa). Again, the facts in our seven jurisdiction-specific chapters reveal that the explanatory power of the economically rational shareholder theory is limited. In fact, the force of non-economically motivated plaintiff shareholders (and even economically irrational plaintiff shareholders) in many of our jurisdictions is striking.

In sum, Chapter 2 demonstrates that no single 'grand theory' can accurately explain or predict how the derivative action functions in Asia. The assumption that the rate of derivative litigation will necessarily be modest merely because a jurisdiction has an 'Asian culture' is absurd. The fact that a jurisdiction follows either the civil law or the common law tradition does not necessarily allow us to predict whether judicial decisions or statutory provisions will be more influential or whether the derivative action will provide strong protection for minority shareholders. Indeed, even the fact that the derivative action is economically inefficient, or even economically irrational to pursue, does not allow us to axiomatically conclude that it will be scarcely utilized.

In this sense, the truth revealed in this book is an 'inconvenient' one. The fact is that the forces that drive derivative actions in our seven leading Asian jurisdictions (and, we suspect, everywhere else) are far too complex and varied to conform to any one grand theory. This means that, to reach an accurate understanding of how the derivative action functions in our seven leading Asian jurisdictions, it is necessary to consider a myriad of local factors, including the specific regulatory framework, case law, economic forces, corporate governance institutions and the socio-political environment, that impact upon derivative actions in each individual jurisdiction. This is the approach taken in the seven jurisdiction-specific chapters of this book. In this respect, the complexity of the derivative action in Asia is the primary touchstone in Chapter 2 and, indeed, this entire book.

II The derivative action from an economic and functional perspective

1 Definition, characteristics and delimitation

a Definition

As this book addresses the regulatory structure and use of 'derivative actions' in various jurisdictions, special attention should be paid to the fact that each jurisdiction has its own unique legal tradition, corporate governance landscape and institutional structure. Under these circumstances, a workable concept of what constitutes a 'derivative action' must necessarily be broad enough to allow for a meaningful comparative analysis while still being precise enough to make sense. With this in mind, for the purpose of this book, 'derivative action' is defined as a (corporate) action by which someone enforces a right that belongs to a company for and on behalf of the company.[21] To provide further clarity to this broad definition, we can identify six features that are normally present in derivative actions:

(1) harm is done to the company;
(2) the harm is normally inflicted by someone who owes a duty to the company;
(3) the organ of the company that is legally empowered to rectify the harm by filing an action for relief in the name of the company has failed to fulfil its pertinent duties, most often because the person with effective control of the organ is the same person who caused the harm;
(4) an exceptional delegation of the company's power to enforce its legal rights is given to another legal person (the 'derivative plaintiff') for the purpose of enforcing the company's right through a derivative action;
(5) the cost of the derivative action is prima facie borne by the derivative plaintiff; and
(6) relief from a successful derivative action flows directly to the company (not to the derivative plaintiff).

In most cases, the derivative plaintiff will be a minority shareholder who enforces the rights of his or her company, but other persons may

[21] This definition evolved from the discussion at the Singapore conference in July 2010; see also Reisberg (*Derivative Actions*), 1, 5f., and Li (*A Comparative Study*), 1–3.

also have the right to pursue a derivative action. Majority shareholders rarely choose to pursue derivative actions, because they can normally avoid the cost and uncertainty of a derivative action by using their formal voting rights or informal economic power to cause the company to pursue its claim directly – making a derivative action redundant. The defendants in a derivative action are normally the directors of the company. However, depending on the jurisdiction's specific regulatory policy,[22] its officers, accountants, majority shareholders or others with a specific duty towards the company may also be sued derivatively if they inflict harm on the company.

It should be noted that some jurisdictions, including the United States, Canada and Germany,[23] also acknowledge a special type of derivative action called the 'double (or multiple) derivative action'. The double derivative action normally arises in the context of group companies, or, more precisely, in the relationship between a parent and a subsidiary company.[24] In this case, a shareholder in the parent company brings a derivative action on behalf of the subsidiary. The right to bring the action is first derived from the subsidiary to the parent company (in its capacity as a shareholder in the former) and then derived from the latter to its plaintiff shareholder.

b Characteristics

The first characteristic feature of a derivative action is the delegation of the right to sue as an exception to the general rule that someone may not claim another person's damages. In principle, if harm is done to a company, it is up to the company, and not to one or some of its shareholders, to decide whether it might seek to redress the injury sustained in its own legal capacity. A plaintiff shareholder's right to pursue a derivative action 'derives' from that right of the company. Although the action

[22] Under Belgian law, to name but one example, shareholders are entitled to file a derivative action for damages only against directors, not against other persons inflicting harm to the company (art. 562, Belgian Companies Act.); see A. Bertrand and A. Coibon, 'Shareholder suits against the directors of a company, against other shareholders and against the company itself under Belgian law' (2009), *European Company and Financial Law Review* 6, 2/3: 270–306, 282; a similar restriction exists in the United Kingdom (sect. 260(5) CA 2006).

[23] Specific regulation in §§ 309f., 317f., German Stock Corporation Act (AktG).

[24] For details of the double derivative suit in the United States, see DeMott (*Shareholder Derivative Actions*), sect. 2:02; for a discussion referring to British law, in which the new regulation of derivative action in the Companies Act 2006 is silent on this issue, see Reisberg (*Derivative Actions*), 202f.

is brought on behalf of the company, the decision to do so is taken outside the company's usual decision-making process.

A corresponding second characteristic is the fact that the plaintiff shareholder acts merely as a 'messenger' who does not seek relief for him- or herself but, rather, for the company. Accordingly, possible damages are, at least as a rule, fully awarded to the company and not the plaintiff shareholder, who does not benefit directly from the action.[25] A derivative action thus typically has a certain 'representative' nature, because the outcome of the suit will indirectly influence all shareholders and not just the plaintiff shareholder.[26] A consequence of this outcome is a severe incentive problem for a plaintiff shareholder, which is exacerbated by the fact that the plaintiff shareholder, at least prima facie, risks bearing all the costs of the proceedings, with only the possibility of receiving an indirect economic gain in the future if the company's share price rises as a result of the derivative action.[27]

A third typical characteristic is the involvement of three parties in a derivative action: (1) the plaintiff shareholder; (2) the defendant director; and (3) the company itself – which may be either formally or informally involved. At least in part, this tripartite arrangement is a function of history. Originally, at least in common law, a derivative action was conceived of as two distinct actions combined into a single proceeding. The first part of the proceeding was an action against the company seeking to force it to bring a claim for relief against a third party. The second part of the proceeding was an action for relief against the third party that had inflicted harm on the company.[28] Today, from a procedural perspective, this historical conception survives in the United States and other common law countries' law in the complicated dual role that is normally assigned to the company in derivative actions: the company is seen as being both a real party plaintiff and a nominal party defendant.[29] In some jurisdictions, however, this tripartite relationship is formally recognized in the substantive (not merely procedural) aspect of the derivative action. For example, in the 2005 German statutory derivative action, at any stage in the proceedings, the company has the right to submit an opinion as well as the right to take over the proceedings in its

[25] This causes severe incentive problems; see infra at 3 a.
[26] See Li (*A Comparative Study*), 3. [27] See also infra at 3 a.
[28] Clark (*Corporate Law*), 639.
[29] See H. Merkt and S. Göthel, *US-amerikanisches Gesellschaftsrecht* [*US Company Law*], 2nd edn. (2006), Frankfurt: Verlag Recht und Wirtschaft, 507.

own legal capacity.[30] A similar rule is known in France, where the company has to be officially involved through its legal representative in the court proceedings.[31]

A fourth characteristic is that the derivative action has historically been the only means by which shareholders can, albeit indirectly, redress a 'reflective loss' suffered by a drop in the company's share price as a result of harm inflicted on the company. If that harm is rectified through a successful derivative action, the share price may rise to pre-harm levels and, in turn, indirectly provide relief for a shareholder's reflective loss.[32] In most, if not all, jurisdictions – even including France, whose *tort* law somewhat exceptionally allows compensation for pure economic loss without additional requirements – such a recovery has traditionally not been allowed under company law by means of a direct shareholder action.[33] More recently, however, the courts in some common law jurisdictions have created narrow exceptions to the general principle that prohibits the recovery of a reflective loss in a direct shareholder action. In addition, the recent expansion of the oppression remedy (which is a personal shareholder action) has in some cases resulted in the court awarding damages to the company if the company is damaged in the course of the oppressive act. Similar to a derivative action, such an award to the company may provide indirect relief for reflective loss suffered by a plaintiff shareholder if the market views the award as returning the company to its pre-harm value. However, as these common law exceptions are extremely narrow, in most cases a derivative action is often the only option for shareholders to be made whole following a reflective loss.

c Delimitation

A derivative action must be distinguished from a direct action, in which the plaintiff shareholder files a suit in a personal capacity and the cause of action belongs to that shareholder. In such actions, the harm inflicted primarily affects the shareholder's own rights, and the shareholder aims

30 See § 148 AktG; see also infra at section IV, 4, e.

31 See Planck (*Aktionärsklagen*), 48ff., with further references.

32 If at all, this is more likely to happen if a small company is involved rather than a large one with a respective market capitalization; see infra at 3 a.

33 For an in-depth comparative discussion of this complex question, see H. de Wulf, 'Direct shareholder suits for damages based on reflective losses', in S. Grundmann *et al.* (eds.), *Festschrift für Klaus J. Hopt zum 70. Geburtstag am 24. August 2010: Unternehmen, Markt und Verantwortung* [*Festschrift for Klaus J. Hopt on his 70th Birthday on 24th August 2010: Firms, Markets and Responsibility*] (2010), Berlin: De Gruyter: 1537–64.