THE SHAREHOLDER DERIVATIVE SUITS: DISFUNCTION AND REMEDIES AGAINST A "PARADOXAL" INACTIVITY

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Abstract

The derivative action exerted by shareholders (*rectius*, by a single shareholder or by a minority of them) falls within the wider topic of the defence of shareholder minorities. Considered as one of the pillars of *corporate governance*, the above-mentioned subject tends to be a control tool as to the accurate execution of the managerial task. Some empirical studies show that, in spite of corporate fraud by managers, in listed companies there are no such lawsuits. This "physiological paradox" – under which the others' indifference enables a few organised individuals to control the company – has urged the need for a deep re-examination of control power over management. According to the European Directive on the Cross-border Exercise of Shareholders' Rights, effective shareholder control is a prerequisite to sound corporate governance and should, therefore, be facilitated and encouraged. But control power over management is usually based on "empty" procedures and frequently false meeting practices. The fundamental "hypocrisy" of corporate governance is due to different quality and quantity of information available for deeply different groups of people. From this point of view, the European Directive makes it easier to exercise some traditional rights, but still does not give a "full" right to be informed about management.

Keywords: corporate governance, shareholders, management

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I. The subject I intend to debate is that of the derivative action exerted by shareholders (*rectius*, by a single shareholder or by a minority of them) in order to assert before the court administrators' managing responsibility[27]. Falling within the wider topic of the defence of shareholder minorities and considered as one of the pillars of *corporate governance*, the above-mentioned subject tends to be a control tool as to the accurate execution of the managerial task.

Although modern limited companies are based on the *majority rule*, it is quite clear to everyone that such a rule can easily lead to discriminatory and iniquitous treatments of minority shareholders.

As everyone knows, within the field of limited companies there are "closed" - and "open" - structured companies: this distinction is based on the level of shareholders' external participation to the company management, reaching the highest and minimum level in closed-structure companies or limited companies and in open-structured companies or public companies, respectively [28]. The more restricted the company's structure the highest is shareholders' interference with the management and, therefore, the lower the need for the defence of minority. In case, instead, of an extremely widespread shareholding (in terms of both capital fragmentation and physical distance amongst shareholders), a little group of shareholders controls the management although not representing the capital majority.

This "physiological paradox" of modern companies has urged the need for a deep re-examination of control power over management, usually based on the frequently false meeting practice (budget inspection and approval, liability action, and so on). Within most legal systems, whether *civil* or *common law*, this re-examination resulted such as the attribution to a single shareholder (*shareholder right*), or to a percentage of capital shares (*minority right*), of the title to exert certain rights.

According to the Communication of the European Commission to the Council and the European Parliament (21 May 2003: «*Modernising Company Law and enhancing Corporate Governance in the European Union — A Plan to Move Forward*»), new tailored initiatives should be taken with a view to enhancing shareholders' rights in listed companies and that problems relating to crossborder voting should be solved as a matter of urgency.

In its Resolution (of 21 April 2004), the European Parliament expressed its support for the

[27] This report summarises the ideas published in the treatise LATELLA, *L'azione sociale di responsabilità esercitata dalla minoranza*, Torino, 2005, *passim*.

[28] The subject is well known to everybody and it has been discussed since the contribution by BERLE and MEANS, *Società per azioni e proprietà privata*, Torino, 1966, 87 s., italian translation of *The Modern Corporation and Private Property*, New York, 1932.

Commission's intention to strengthen shareholders' rights, in particular through the extension of the rules on transparency, proxy voting rights, the possibility of participating in general meetings via electronic means and ensuring that cross-border voting rights are able to be exercised.

Finally, according to the European Directive on the Cross-border Exercise of Shareholders' Rights (n. 2007/36/EC), effective shareholder control is a prerequisite to sound corporate governance and should be facilitated and encouraged.

Of course, the introduction of individual or minority rights implements talks between the control group (reference managers and shareholders) and those who are usually excluded, increasing at the same time the so called *frivolous claims*.

We all know that the main legal systems focus on two essential issues:

1. on the one hand, ensuring a certain "running agility" to the limited company, which implies sacrificing the minority's interests for the majority's ones;
2. on the other hand, preventing management control tools and minority defence tools from turning into blackmailing activities aiming at reaching a personal advantage otherwise not realisable[29];

All the studies carried out within this field show that legal systems have faced the issue relating to the balancing between opposed abuses and highlight a relevance threshold as to the need for defence, which usually stands between the unit (each shareholder can take the initiative despite the owned capital) and the 5 % of the capital (which can be represented by the shareholder alone or by a group of shareholders).

From this point of view, the European Directive made the choice to fix just a "top threshold" concerning (a) the right to put items on the agenda of the general meeting and (b) the right to table draft resolutions for it. Where any of the mentioned rights will be subject to the condition that the shareholder hold a minimum stake in the company, such minimum stake shall not exceed 5 % of the share capital.

Therefore, in some cases, the shareholder's position appears as assigning a kind of "veto power" to the individual, while in many other cases it is necessary that shareholders join up in order to exercise their own privileges and rights.

There is a deep and unexplained vacuum between the so called "minority remedies" and the information rights.

From this point of view, liability represents a typical remedy that corporate law assigns first of all to majority shareholders in order to obtain compensation for damages caused by managers to corporate assets. It is a "reparatory" remedy and it is provided for in almost all national regulations as it is directly connected to the legal structure of the fiduciary contract between the company and the managers. Liability also is a deterrent: managers should be afraid of being sued for damages caused to the company by breaching the managerial mandate; then, they should behave fairly in the sole interest of the shareholders.

Nevertheless, according to the empirical analysis, the endemical complicity between majority shareholders and managers represents an obstacle to the frequent exercise of liability action.

After the rule in *Foss v. Harbottle*, derivative action originated from the awareness that the company, being unable to rely on shareholder majority's initiative, will necessarily have to count on someone who is external to the control group, i.e. single shareholder or minority shareholders. They do not receive by law an autonomous action, but a legal action "resulting" from the main situation being the company's concern. Therefore, any possible damage recognised to the shareholders would be entitled to the company.

Of course, derivative action also has a control function on the company management, which could be exerted by minority shareholders in a much stronger way if compared to the shareholder majority.

So, the question is "why there are no shareholder derivative suits in Europe?"[30].

II. First of all, let's see what are the available legal model in a few States.

II.1) *United Kingdom/United States* – A first reference is due to the USA law, considered a model by all western lawmakers and, at least before the UK-Companies Act of 2006, main verification field of the corresponding English law.

The *derivative suit* gives the single shareholder the right to sue managers in order to directly assert towards them the compensation claim that the company omits to start.

The relationship between the shareholder and the company is the legal base of the procedural power recognised to the shareholder and represents the necessary and sufficient reason for the shareholder to be recognised a *derivative* procedural power (prof. LUTTER would define it as a *Mitgliedschaftsrecht*).

In the USA legal system the *derivative suit* corresponds to the recognition of a real *individual right* to the shareholder, the origin of which can be

[29] This is what would happen, for example, in the case of a compromise agreed by managers even just to avoid the image damage resulting from groundless judicial proceedings (see ROMANO, *The Shareholder Suit: Litigation without Foundation?*, in *J. L. Econ. Org.*, 7 (1991), 55 ss.).

[30] See and GRECHENIG, KRISTOFFEL R. and SEKYRA, MICHAEL, *No Derivative Shareholder Suits in Europe - A Model of Percentage Limits and Collusion* (May 1, 2010). *University of St. Gallen Law & Economics Working Paper* No. 2010-07; *Columbia Law and Economics Working Paper* No. 312; *MPI Collective Goods Preprint*, No. 2010/15. Available at SSRN: http://ssrn.com/abstract=1591402.

traced back to the famous decision within the *Foss v. Harbottle*[31] case, taken in England in order to assert the full application of the majority principle and, with reference to our debate, the possibility for the shareholder to lay company claims under authorisation by management.

Unlike the poor success within the English legal system, the same institution was quite successful in the USA thanks to a series of positive factors amongst which the existence of a set of rules regulating legal costs (*contingent fee*) particularly favourable to lawyers who still do their best to recruit litigious shareholders. But, on the opinion of many authors, the factor affecting the balanced functioning of *derivative suit* is just the *contingent fee* mechanism, which pulls it away from its *monitoring and pression-on-corporate-policy* functions.

II.2) *France* – According to the *Code de Commerce* (*ordennance* n. 2000-912, dated September 18th, 2000): «*besides the compensation action resulting from damages suffered personally, shareholders can exert the company liability action against company managers or directing managers both individually and grouped according to the terms provided for by art. 225-120 and by the corresponding decree*» (art. L. 225-252). The remedy is therefore based on the *shareholder derivative suit* and, also in this case, the "prejudice" which the single shareholder is subject to is represented by the "reflected" damage to the stake due to the decrease in corporate assets, which appears as "spread" because of the stake itself.

According to French law, if legal charges cannot be met by the *single* shareholder, managers can be sued according to some legal economy criteria requiring the creation of a "group" of shareholders qualified as to capital and representing shareholders' interests (in listed companies «... at least 5% of those having the right to vote»: art. L. 225-120, par. 1, *cod. comm.*; in "closed" companies, the «twentieth part of the share capital»: art. 200, l.d. n. 67-236). Below these percentages, legal action can be undertaken by the single shareholder only.

This institution shows two interesting features: 1) first of all, the *grading* of qualifying thresholds according to a decreasing scale of the capital spreading amongst public; 2) second, the unimportance of shareholders' withdrawal from the trial (art. 200, last par., *cod. comm.*) in order to assure the stability and regular carrying on of the trial itself.

II.3) *Spain* – Art. *134* of the *Ley de Sociedades Anonimas* suggests a more severe solution in comparison to the USA and French legal systems, acknowledging the company with a primary legitimation in the exertion of the compensating action and minority shareholders and company's creditors with a merely *subsidiary* legitimation. Therefore, the remedy is solely and strongly "derivative" so as to give the minority's action the technical nature typical of subrogation.

Spanish law makers have regulated this institution combining two different regulations (art. 100 and 134 *LSA*), according to which shareholders representing at least 5% of the share capital are entitled to first ask for the convocation of the general meeting in order to decide on the exertion of the liability action. Shareholders' legitimation, instead, only arises in the following cases: a) if managers refuse the convocation of the general meeting; b) if the liability action is not exerted within the 30 days following the positive response for the convocation of the general meeting; c) if the minority's proposal is refused by the general meeting. Therefore, the characteristic of the Spanish system lies in the technique used to activate the minority's control over management: the higher the company's or managers' "indifference" towards the qualified minority's calls for intervention the more intense the minority's participation to the merit rating supporting the need for a trial defence of the company's compensation claim[32].

II.4) *Germany* – Germany has recently reformed rules and regulations relating to derivative action, introducing some correctives in July 2005 (*Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts [UMAG]*, July 8th, 2005, effective from November 1st, 2005).

The previous *Geltendmachung von Ersatzansprüchen* couldn't be exerted by shareholders as such, not even if organised in qualified groups: it could only be exerted by the company, possibly, following the minority's stimulus (§ 147, *AktG*).

[31] *Foss v. Harbottle*, 2 Hare 461, 1843; for main references, DEMOTT, *Shareholder Derivative Action*, cit., § 1:03, at first (9th century) it was a *representative litigation* used by English *joint stock corporations'* funding partners in order to re-establishment of their own rights. Before then, during the 18th century, the same action used to be implemented in order to notify the breach of the duties imposed to *trustees* within *charitable organizations* (see also FERRARA – ABIKOFF – GANSLER, *Shareholder Derivative Litigation*, cit., § 1.03; BISON, *Mißbrauch der Anfechtungsklage durch den Aktionär. Eine rechtsvergleichende Analyse des US-amerikanischen und des deutschen Rechts*, Frankfurt a.M., Berlin, Bern, New York, Paris, Wien, 1997, 93 ss.). Of course, see WIEDEMANN, *Gesellschaftsrecht – Ein Lehrbuch des Unternehmens- und Verbandsrechts*, *Band* I, *Grundlagen*, München, 1980; ID., *Orgaverantwortung und Gesellschafterklage in der Aktiengesellschaft*, Opladen, 1989.

[32] On the other hand, it must be said that this tortuous course imposed to minority before coming to the exertion of its action represents a strong deterrent apparently resisting also to the reform proposal (2002 *Propuesta de Código de sociedades mercantiles*). For some interesting comparison with the Chilean Corporate Law, see NUNEZ, DAVID and PARDOW, DIEGO G., *Why Don't Shareholders Sue? Derivative Actions as a Test of Convergence in Chilean Corporate Law* (May 25, 2008). Available at SSRN: http://ssrn.com/abstract=1399470.

German lawmakers had therefore introduced a mere *Iniziativrecht* (initiative right), rather than a remedy based on the Anglo-Saxon *shareholder suit* (action right). According to it, in case of management's inactivity, the shareholders' minority could obtain by the judicial authority the appointment of trial representative for the exertion of the compensating action falling on the company.

Since 2005, derivative action regulations are provided for by the § 148 *AktG* according to which shareholders who, at the time of the claim submission, own a number of shares representing at least 1% of the capital or having a nominal value of at least 100.000 Euros, can ask the court to act against managers on behalf of both the company and themselves.

The judge has to take into account whether 1) shareholders were such at the time of the breach of the rules, 2) shareholders had previously asked the company to exert the liability action, 3) it is suspected that the company suffered from damages caused by its managers, 4) the company interest does not interfere with the exertion of the action. Therefore, it is the judge the one who is in charge of balancing the suspect of serious management defaults with the company interest by using a system which mostly resembles the preventive trial of American courts as to the legitimacy of the quarrel.

The expense system basically supports the minority taking the initiative. However, it is necessary to distinguish between the procedure of acceptance of the action claim and the possible following merit judgement relating to managers' responsibility: in the first case, should the claim be rejected, costs would be met by shareholders unless an interest of the company (unknown to shareholders) for the claim to be rejected becomes evident; should the claim be accepted, costs are met by the company. In the second case, the company always has to refund procedural costs to shareholders unless their claim has been accepted under false data produced to the judge.

II.5) *Italy* – Shareholders can exert the liability action if they represent at least 2.5% of the capital and 20% of the capital in public companies and closed companies respectively (art. 2393-bis c.c.)

The reform (law decree n. 6/2003) has removed a significant obstacle to the exertion of the action, i.e. the continuing ownership of shares for the six months preceding the start of the trial. The issue relating the possession of the required stock share during the whole trial still exists. In my own opinion, the free circulation of the capital and the exertion of the liability action cannot hinder each other. Therefore, in case of no exceptions, the lack of the required stock share (for example, because of the transfer of part of it) does not influence the trial once properly started[33].

The company has to be sued together with managers who damaged its assets. This demonstrates how the minority's initiative cannot be taken forward regardless the company's behaviour throughout the trial: during the trial, the company still is the one basically having the right to be compensated.

As to procedural costs, also in Italy the system does not particularly benefit the acting shareholders and lawyers' payment system has only recently accepted the agreement of a "contingent fee " pact, according to which the defendant is entitled a percentage of the compensation obtained at the end of the trial (see 'Decreto Bersani', law decree n. 223/2006).

At present, there are no suits exerted in Italy and, therefore, no data available.

III. Finally, everyone can see that derivative action is always functional to the control activity that shareholders can exert over management. This function is basically assured by ensuring shareholders the right to lay the company claim, obviously without or whatever a preliminary decision of the meeting.

Therefore, derivative action appears as essential in modern *corporate governance* systems as it qualifies as one of the main "actors" for an efficient company management and as it strongly *appeals* all those investors looking for capitalistic markets being sufficiently protective as to minorities' interests.

Surprisingly, as we all know, in spite of corporate fraud there are practically no such lawsuits in continental Europe.

So far, no theoretic models have been developed to explain the absence of derivative suits. Someone argued that the shareholders are subject to a "free rider" problem. Derivative suits are brought on behalf of the corporation, so that the damage payments go to the corporation as a whole; however, the litigation costs have to be borne by the plaintiff, in case he loses. These asymmetric payoffs would cause every single shareholder to wait for other shareholders to bring an action and, in the end, no one would sue the managers.

I'd like to focus essentially on three problems causing the lack of derivative action: 1) percentage; 2) costs; 3) information rights.

Percentage and costs: Regarding the cases of a preliminary decision of the general meeting on the exercise or continuation of a derivative action (see Spain, Germany), I think that it is certainly correct to fix a "top threshold" necessary to exercise the shareholder voting rights. For example, it would be around the 5 % of capital stock.

But it could be more important to *grade* legitimation thresholds (to vote or to sue) relating to the distribution of stocks in the market: the more widespread the capital between the shareholders, the lower the percentage request. This simple correction of national existing legislations could better ensure the smooth and effective exercise of shareholders rights requested by the European Directive.

Besides, if the action is brought by a entitled

[33] LATELLA, *L'azione sociale di responsabilità esercitata dalla minoranza*, cit.

group of shareholders, this group could apply to the court for an order directing the company to indemnify it in respect of costs incurred or to be incurred in connection with the proceedings. In this case, the court could also consider that the proceedings may be brought on such terms and conditions as the court thinks fit. So, if shareholders would bring proceedings in such a different way from such the court decided, the expenses should be paid by the group.

But the theme I consider really fundamental to allow a full and effective exercise of shareholder derivative action, is that of information rights.

As we all know, the European Directive n. 36/2007 does not introduce a uniform regulation of certain rights, but essentially of the *way* to exercise some voting rights by using the modern communication systems and of the *terms* to be respect in proposing the agenda for the general meeting.

The European Directive offers some interesting objective to be reach from the States:

- Member States shall require the company to use such media as may reasonably be relied upon for the effective dissemination of information to the public throughout the Community (art. 5, 2);

- The convocation shall (b) contain a clear and precise description of the procedures that shareholders must comply with in order to be able to participate and to cast their vote in the general meeting. This includes information concerning those rights being made available on the Internet site of the company and where and how the full text of the documents and draft resolutions may be obtained (art. 5, 3);

- Member States shall ensure that for a continuous period before the day of the general meeting (21 days), the company shall make available to its shareholders on its Internet site this draft resolution or, where no resolution is proposed to be adopted, a comment from a competent body within the company for each item on the proposed agenda of the general meeting.

On my opinion, what's really significant is the provisions in art. 6, concerning two typical "minority rights":

- the right to put items on the agenda of the general meeting, accompanied by a justification or a draft resolution to be adopted in the general meeting;

- the right to table draft resolutions for items included or to be included on the agenda of a general meeting.

Member States may provide that the right to put items on the agenda may be exercised only in relation to the annual general meeting, provided that shareholders, acting individually or collectively, have the right to call, or to require the company to call, a general meeting which is not an annual general meeting with an agenda including at least all the items requested by those shareholders.

We all know that the exercise of the shareholder derivative suit does not necessarily involve the decision of the general meeting. This happens, for example, in Italy, in France, in UK. In some other State, the general meeting is called to decide if the action has to be continued by the company in such its own name.

So, what is the link between the rights provided by the European Directive to be exercised in the general meeting and the shareholder derivative suit? This link is represented just by the information right.

In my work on minority protection, I've tried to demonstrate that there is no efficient derivative suit without a full, penetrating and preliminary information received by the claiming shareholders.

That is to say, that national legislations have to ensure the effective use of shareholders rights by imposing further obligations on companies concerning the right to ask for information about management, accounts, reports and so on. It is not important to get informations about management during a generel meeting, but rather to get them as soon and detailed as possible.

From this point of view, the last UK-Companies Act (Sec. 146, 431, 432, 1145) introduces some interesting provisions: Shareholders and holders of debentures are entitled to be provided, on demand and without charge, with a copy of:

(a) the company's last annual accounts,

(b) the last directors' remuneration report,

(c) the last directors' report,

(d) the auditor's report on those accounts (including the report on the directors' remuneration report and on the directors' report).

Maybe it is not sufficient.

Since a shareholder derivative suit cannot be efficiently filed without a full range of informations on the activity of managers, Member States should impose on companies the obligation to deliver informations to a certain percentage of shareholders, provided that the same shareholders has given a specific request to the company stating, for example:

(i) the cause of action and a summary of the facts and persons on which the proceedings are to be based;

(ii) the members comprising the group and the grounds on which it is alleged that those members constitute an entitled group.

In short, the result that the European Directive should have achieved, even according to its assumptions, was probably to provide further shareholder controls on management activity and corresponding remedies. On my opinion, this supplementary provision of the European Lawmaker could have broken the link existing between management and auditing, thus encouraging proceedings against managers and filling the actual vacuum of shareholder activism[34].

[34] For the most recent developments, see VERMEULEN, ERIK P. M. and ZETZSCHE, DIRK A., *The Use and Abuse of Investor Suits: An Inquiry into the Dark Side of Shareholder Activism* (January 25, 2010). *European Company and Financial Law Review*, Vol. 7, No. 1; TILEC Discussion

Paper No. 2010-001; CBC-RPS Paper No. 1/2010. Available at SSRN: http://ssrn.com/abstract=1428901; see also KERSTING, CHRISTIAN, *Broadening of the Right to Ask Questions as a Result of the Shareholders' Rights Directive (2007/36/EC) (Ausweitung des Fragerechts durch die Aktionärsrechterichtlinie)* (December 7, 2009), *Zeitschrift für Wirtschaftsrecht* (ZIP), p. 2317, 2009; CBC-RPS No. 0045/09. Available at SSRN: http://ssrn.com/abstract=1520453; ID., *Electronic Participation in General Meetings and the Right to Ask Questions - Implementing the Shareholders' Right Directive (2007/36/EG) (Das Auskunftsrecht des Aktionärs bei elektronischer Teilnahme an der Hauptversammlung (§§ 118, 131 AktG))* (February 10, 2010), *Neue Zeitschrift für Gesellschaftsrecht* (NZG), p. 130, 2010; CBC-RPS No. 0047/2010. Available at SSRN: http://ssrn.com/abstract=1590213.