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Comparative Derivative Litigation Analysis

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Abstract

Shareholder-derived litigation refers to the litigation system when the legitimate rights and interests of the company are infringed by others, especially by the controlling shareholders, parent company, directors, and managers. As an important system to protect the interests of shareholders shareholder derivative actions have been controversial in practice and do not work well as a remedy. This article will focus on the advantages of relaxing derivative actions while pointing out the problems in current judicial practice and suggesting possible solutions for improving derivative actions in the future.

Keywords: shareholder, Derivative Litigation

1. Introduction

The company is negligent in exercising its right to sue. The shareholders who meet the statutory requirements file a lawsuit against the infringer for the company's benefit to pursue its legal responsibilities. The shareholder derivative action system effectively safeguards the company's and its shareholders' legitimate rights and interests. However, it also poses risks and challenges to the regular operation of the company and affects the stability of the company. Due to the particularity of the derivative litigation system, the plaintiff of this kind of litigation must be a shareholder and directly file a lawsuit in the people's court in his name. The purpose of the lawsuit must be for the interests of the company. The litigation interests ultimately belong to the company. However, the litigation risks are borne by the shareholders involved, which leads to the impact on shareholders' enthusiasm for judicial practice. With the development of the market economy, the separation of ownership and operation of the company has become an inevitable result, and the derivative litigation system has become a barrier to protecting shareholders' rights and interests. In judicial practice, shareholders often have to pay a significant price, which has led to derivative litigation becoming an expensive way to correct mistakes, consume court resources, hinder the regular operation of the company and damage the company's image in the market, and whether to relax the derivative litigation system has caused widespread controversy.

2. The Benefits of Derivative Action

2.1 Protection of Minority Shareholders' Rights

Derivative actions protect the rights of minority shareholders and limit the ability of significant shareholders to manipulate the company for their benefit. Under the principle of majority voting of capital, a majority shareholder may use the advantage of voting rights to manipulate the shareholders' meeting or the board of directors to the detriment of the company's interests or the rights and interests of minority shareholders. The majority shareholders are not directly involved in the management of the company's day-to-day affairs, and the company's management power is exercised mainly by the directors, managers, and other senior management. This management structure of the company is very likely to leave room for senior management to abuse management power and damage the rights and interests of the company[1]. In addition, it is also true that senior management of companies receives excessive remuneration. Some senior management even self-dealing for personal gain, causing significant losses to the company's property. The shareholder derivative action system is crucial in defending the interests of the business and, afterward, defending the rights and interests of shareholders, particularly minority shareholders. The derivative action system offers an effective remedy for shareholders by encouraging them, particularly minority shareholders, to monitor corporate management for the benefit of the company and shareholders rather than just for their interests. This discourages management from abusing their management rights to the detriment of the company and shareholders[2]. The derivative action system provides minority shareholders a tool to defend their legal rights and interests. The derivative action regime allows minority shareholders to assert their legal rights and interests. Although the beneficiary of the action is the company as a whole, there is no doubt that in this way, minority shareholders themselves can defend their rights and interests.

2.2 Ensure Effective Company Operations

The shareholder representative litigation system safeguards the interests of the company and the rights of shareholders, strengthens the supervision of the business activities of the company's directors and other senior management, and ensures the active operation of the company[3]. Firstly, a derivative action is an alternative measure if the company cannot bring a direct action. When executives act against the company for their benefit, it is no longer possible to hope that they will bring a lawsuit against themselves on behalf of the company. This is where a derivative action has a positive deterrent effect by allowing eligible shareholders to sue executives in the company's name. Secondly, derivative actions reduce to some extent the inefficiencies associated with collective shareholder action precisely because they are often premised on the failure of a large number of shareholders to agree, and there is a degree of cost savings for a single shareholder or minority shareholder to bring a derivative action. Finally, shareholders can ameliorate various unjustifiable corporate practices through derivative actions, such as excessive management remuneration, abuse of affiliated company relationships, and illegal procedures for providing loan guarantees[4].

3. Current Issues in the Derivative Action

3.1 Excessive Costs

Shareholders of a company often face a dilemma in bringing a derivative action, as it means that the company may suffer more damage than the benefits of the action if it is brought. This may also include non-economic harm, such as the potential for the lawsuit to affect the company's long-term earnings and thus prevent the company from raising capital. In general, the benefits of the lawsuit may be far less than the damages[5]. In addition to the costs of litigation, there are also hidden costs. Litigation may interfere with corporate decision-making; management must take time out to deal with the current litigation challenges occurring in the company, which means that management must distract themselves, litigation may consume too much management time, and management could otherwise look for suitable investment opportunities or concentrate on their jobs. However, they must find ways to deal with litigation when litigation occurs. Incalculable costs are incurred as litigation affects the company's regular operations, which may lead to the departure of core members of the company. A critical employee's departure might be the outcome of this[6]. Boards may spend money they would not otherwise to avoid litigation, even in the absence of a lawsuit or the immediate prospect of one. Board positions are less appealing, and risk-taking is reduced due to directors' worries about potential legal liability for choices, adding more expensive paper trails. Directors will likely engage more specialists than needed and preserve lengthier paper trails than is legally required to avoid accountability. In the lack of certainty, it is safer to have too much than not enough.

3.2 Low Success Rate in Litigation

Minority shareholders often face difficulties in bringing derivative actions. In addition to the need to prove that one of the exceptions to the rule in Foss v. Harbottle1[7] applies in the court's adjudication process, the court added several additional requirements, such as that the plaintiff must have "clean hands"[8]. Since the prerequisites for the commencement of derivative action are already very demanding, this has resulted in very few cases of a derivative action, and only a sufficient number of cases can have a deterrent effect. However, derivative actions do not occur very often in judicial practice. When litigation costs are higher than settlement, shareholders often choose to settle. Instead of going through complicated legal proceedings, some minority shareholders prefer to settle with the defendant because when a minority shareholder initiates a lawsuit, the regular operation of the company's share price is also affected when the interests of both parties are compromised. If the minority shareholders can obtain more benefits through settlement, they will drop the litigation. Due to the low success rate, shareholders must consider the costs of unsuccessful derivative actions. In contrast to US law, Commonwealth countries such as the UK and Australia have a "loser pays" system for legal costs. This means that the loser of a case is responsible for his or her legal costs and the costs of the winning opponent[9]. Where success is uncertain, "loser pays" is a severe threat to shareholders bringing derivative actions: unlike the US, where the UK plaintiff "pays his or her own" legal costs regardless of success, the UK plaintiff who loses must pay the legal costs of both parties, with even more significant implications than the US plaintiff.

4. Restrictive Provisions for Derivative Actions in Various Countries

4.1 Conditions for Initiating Derivative Action

Modern company law is faced with a dilemma on derivative action. On the one hand, the company law focuses on the democratic nature of the company and the equality of shareholders and requires that minority shareholders be allowed to bring derivative actions in the name of the company; however, if the company law unconditionally allows shareholders to bring actions, then the company may face a large number of lawsuits and waste judicial resources. Different countries, therefore, impose numerous restrictions on the conditions for bringing derivative actions, such as the contemporary ownership rule[10], the clean hand rule[11], good faith[12], and ownership by a certain number of shareholders for a certain period[13]. In the UK, some US states, and Australia, when a shareholder commences a derivative action, it is not required that the shareholder be a shareholder of the company at the time the cause of action accrues; however, the vast majority of US state corporate law still requires the suing shareholder to be a shareholder of the company at the time the cause of action accrues[14]. Whether to adhere to this rule is still one of the controversial issues, with many arguing for its abolition because the shareholders are suing in the interests of the company, and the rights of the company should not be limited by when the shareholders acquire their status. Canadian corporate law imposes a subjective good faith requirement for shareholders to bring derivative actions, which the courts can dismiss for lack of good faith if the shareholder seeks to use the action for his or her benefit to settle with the board and thereby benefit himself or herself[15]. Although the issue of good faith is a matter of the plaintiff's subjective motivation and has nothing to do with the case itself, it effectively reduces the number of cases deriving from litigation, prevents the diversion of judicial resources, and prevents the plaintiff from seeking to benefit from it. In Asia, the Taiwan Company Law of China requires shareholders to hold 10% of the total number of issued shares to initiate a derivative action. Japanese company law requires shareholders to have held their shares for more than six months before they can commence a derivative action, which only imposes a time requirement and not a shared requirement[16].

4.2 Conditions of Guarantee for the Derivative Action

In order to prevent shareholders from initiating derivative actions at will, wasting judicial resources, and reducing the number of shareholders acting for their benefit, many countries have required plaintiff shareholders to provide security at the time of prosecution. Under US law, shareholders are required to provide security for the costs of litigation, including damages and attorneys' fees incurred by the company due to its liability to the defendant, sometimes to tens of millions of dollars. For this reason, corporate law provided that minority shareholders could help each other by intervening in related litigation and sharing the cost of the guarantee or by being able to meet the legal requirement of 1% of the shares or $25,000 to be exempted from the guarantee, which was repealed in the US in a subsequent amendment to the law so that the guarantee would only be provided if the court deemed it necessary[17]. In Japan, although there are provisions for the guarantee in company law, the court will only require a guarantee at the defendant's request if the defendant claims that the plaintiff is suing in bad faith[18]. In Taiwan China, however, there is no restriction on whether the plaintiff is in bad faith, and the plaintiff must provide security for the case as long as the defendant wishes to apply to the court[19].

5. Future Solutions

Due to the unique nature of derivative actions, countries have imposed strict restrictions on the conditions for their commencement, the extent of which varies from country to country. In addition to this, among the various mechanisms for controlling agency costs, derivative action is not the most critical and commonly used regulatory measure and, in contrast to other mechanisms, is an ex post facto measure, in a complementary position and the last line of defence for shareholders. However, a blanket lifting of the restrictions on derivative actions would inevitably have many adverse effects. However, it is true that concerning the specific details of the derivative action, many of its restrictions could be further lifted to make it more efficient in protecting the interests of minority shareholders. For example, there should be no restriction on the shareholder has been a shareholder in the company at the time the cause of action arose; after all, the shareholder is acting in the interests of the company rather than his or her interests, and the ultimate beneficiary is the company. Secondly, the shareholding requirement for shareholders to initiate derivative actions can also be suitably reduced, but the exact percentage to be reduced should also be determined by each country according to its own national conditions. Suppose the shareholding requirement for shareholders is too high. In that case, it will be challenging to protect the interests of small and medium shareholders, and many small and medium shareholders will even have to be forced to accept such a fact[20]. Thirdly, the Canadian approach is more efficient regarding whether a plaintiff in a derivative action is required to provide security. This is because if without examining whether the plaintiff is acting in good faith or bad faith, the court requires security from the plaintiff simply because the defendant has made a claim, this undoubtedly results in the plaintiff being in a very passive position[21]. In general, the conditions for initiating a derivative action are just harsh. It would be unfair to the plaintiff if strict measures were still taken against him after he initiated the action. Therefore, different countries can learn from each other's more effective provisions in each other's laws and make the best of them to improve their laws.

6. Conclusion

Derivative actions are an essential part of corporate law in balancing the interests of large and small shareholders. However, whether to relax the conditions for initiating derivative actions has sparked widespread controversy. A comparison of the provisions on derivative actions in the company law of different countries demonstrates that relaxing the conditions for initiating actions at this stage still raises many problems. While the derivative action is an effective mechanism to protect minority shareholders' rights, it is undeniable that some minority shareholders use it as an essential tool in business negotiations to settle with directors for their benefit. In addition, the wrongful commencement of derivative actions wastes judicial resources and increases the courts' workload. Generally speaking, a legal system that is established and survives for a certain period does not have its roots in a mirage, nor is it an accidental creation of a moment of inspiration, and it is born out of the needs of contemporary social life. The need to balance the interests of large and small shareholders has been tested over the past century. Despite its problems, it is still considered an essential mechanism for minority shareholders to protect their rights and interests. Excessive relaxation of the conditions for initiating derivative actions or strict requirements for initiating derivative actions would be disastrous for the company's development. If the pendulum swings too far in either direction, it would be unfavorable for economic development. In addition, each country has a different level of economic development, and there is still a large gap between the economic development of developed and developing countries, which is due to historical reasons and is objective. In other words, it is possible to relax the conditions of a derivative action. However, different countries need to develop more specific policies to clarify the details of the relaxation in accordance with their national circumstances and transition gradually in line with the pattern of economic development. A sudden relaxation of the conditions for derivative actions may not only be impossible for shareholders and companies to adapt to in a short period of time, but may also be counter-productive.

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[7] Foss v. Harbottle, (1843). 2 Hare 461; Prudential Assurance Co. Ltd. v. Newman Industries Ltd. (No. 2) [1982] Ch. 204, 210. In that case, the majority of the shareholders of the company voted not to sue the directors after the minority shareholders had requested the company to sue them for misconduct. The majority of the shareholders voted not to sue the director. The minority shareholders did not comply with the resolution and brought proceedings before the court to enforce the director's liability to the company. The court held that the director's unsuitable conduct, although damaging to the company, was binding on the company by virtue of its ratification by a majority of the shareholders and that the minority shareholders were therefore precluded from suing for such conduct. The court dismissed the minority shareholder's action. The rule in this case is also known as the "majority rule" because for the first time, the right to hold the wrongdoer liable was given to the majority of shareholders who had the right to vote in the company.

[8] See Gower, Principles of Modern Company Law, 6th edn., by Paul Davies (London 1997), p. 668; Gore-Browne on Companies, 44th edn., vol. 2, para. 28.8; Law Commission Consultation Paper No. 142, Shareholder Remedies, para. 5.18.

[9] J Kirkbride, S Letza and C Smallman, 'Minority Shareholders and Corporate Governance: Reflections on the Derivative Action in the UK, the USA and in China' (2009) 51 *International journal of law and management* 206.

[10] The shareholder bringing the derivative action was a shareholder of the company at the time the cause of action arose and has been a shareholder of the company since that time.

[11] The shareholder bringing the derivative action must not have expressly approved, ratified or acquiesced in the breach and misconduct of the director. (b) the shareholder has not expressly approved, ratified or acquiesced in the breach. If a director's the offence or misconduct of a director has been committed since the shareholder has approved, consented to or acquiesced in (a) if the Director has, since the occurrence of the offence or misconduct, approved, consented to or acquiesced in such act he shall be guilty of an offence for lack of (b) if the Director has, since the occurrence of the offence, approved, consented to or ratified the act, he shall be disqualified for lack of "clean hands "and he shall not be entitled to such The right to bring such an action.

[12] The plaintiff must have a pure motive in bringing the action and must bring the action on behalf of the company solely on the basis that the company's interests have been harmed.

[13] A shareholder who is subrogated to a derivative action by a company must own the amount of shares within the limits of the law for a period of time.

[14] M Zhang, (1998). Derivative litigation research, *Journal of Law and Society Development, 6,* 4.

[15] ibid

[16] ibid

[17] Section 49 of the Model Business Corporation Act.

[18] Article 267 of the Commercial Law of Japan.

[19] Section 214 of the Taiwan Companies Act.

[20] A Boyle, (2002). Conflict of Laws and Derivative Actions, *Company lawyer,* 23, 263.

[21] Ibid