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Shareholder Derivative Litigation System: Legal Integration and Comparative Study

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Abstract

Shareholder derivative litigation has been practiced for more than one hundred years since its birth in the U.S. Although criticism has never ceased, more and more countries are are integrating shareholder derivative litigation with their own civil and commercial laws as well as litigation laws. It provides a new means for minority shareholders to regulate corporate executives in the context of the separation of ownership and operation of a company. As the system is still flawed, different systems have been developed in various countries to prevent abuse of shareholder derivative litigation in order to adapt to local corporate prosperity. This paper focuses on providing a new perspective on the soundness of the system by comparing the U.S. and Chinese shareholder derivative litigation in various aspects, such as the conditions for filing a lawsuit, the status of the parties, and the supervision of the courts.

Keywords

Shareholder derivative litigation; Legal integration; Comparative study.

1. Introduction

A derivative litigation is a lawsuit brought by one party on behalf of another because the other party has an interest in it. Derivative litigation is called representative action in civil law system, literally this particular legal system is originated from the power of the plaintiff, because of the interest in a particular subject, and then derived from the right. The plaintiff files a lawsuit on behalf of this subject when the interests of this subject are harmed, and seeks damages in the name of this subject. Such a derivative litigation system originated in equity of Britain in the mid-19th century, but was soon accepted and developed by the American courts and recognized by the Supreme Court of the United States in 1855. At that time, Britain had already completed the industrial revolution, and the disadvantages caused by the high concentration of large companies began to emerge, requiring a corresponding system to monitor and prevent the management of the company from abusing its power to achieve the possibility of personal gain. In Britain and the United States, it was generally agreed that shareholders should be allowed to sue on behalf of the company under certain conditions, and shareholder derivative litigation was born and gradually developed. This paper presents a comparative study of legal integration and comparison in the shareholder derivative litigation system by examining how shareholder derivative litigations have been accepted in other countries or in the world at large, the main driving forces in this process of legal integration, and finally how the law operates in different countries and what causes it to operate in different ways.

2. Legal Integration of Shareholder Derivative Litigation

The shareholder derivative litigation in the form of legal-cultural interaction is mainly done through the legal integration method as it is being absorbed by other countries in four different ways through borrowing, succession, transplantation and integration. For example, the

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managers in Chinese listed companies have absolute dictatorial power over the company, and it is difficult for outside directors and company supervisors to play a supervisory role, and the decentralized owners have lost control over the company and become the ultimate victims of the company's poor business decisions, so China migrates the U.S. shareholder derivative litigation legal system into its own country or the corresponding legal sector system. In contrast, Japan is special, because Japan already has a shareholder class action, but unite all the small shareholders is a very difficult thing, Japan will refer to shareholder derivative action, a single shareholder can take action to unite the country already has a class action and representative action to reform derivative litigation. By representing other minority shareholders, a single shareholder can provide relief for all shareholders with the same status. This is a shareholder derivative litigation in different countries in different legal systems and legal culture in the process of mutual encounter, collision, conflict, mutual influence and penetration, acceptance and adaptation of their own system of cultural evolution process, that is, the legal integration of shareholder derivative litigation.

Shareholder derivative litigation is a special form of class action because the plaintiff shareholders in theory actually represent the interests of all shareholders, i.e., the corporation itself. These actions were originally considered a type of class action under Rule 23 of the Federal Rules of Civil Procedure. the 1966 revision created Rule 23.1, a separate rule that applies to derivative litigations. Other countries accepted it because of the development of the market economy, the increasingly active activities of legal persons, mainly corporations, and the gradual separation of their ownership and operation as they grow, the difficulty of protecting the rights and interests of minority shareholders, and the fact that corporate order cannot rely solely on government or court regulation, and the need to give full play to the power of the market to check and balance the wrongful acts of corporate management, which is more effective and less costly. Although shareholder derivative litigation is not the primary system for regulating corporate management, such as outside director oversight, shareholder voting, and government regulation can inhibit corporate management from abusing their power and causing damage to their own power. But each of these measures has limitations, and the intuitive compensatory and deterrent effects of shareholder derivative litigations have unparalleled institutional advantages, intersecting with other systems to establish a more diversified system of protection.

Throughout the research results of the United States, Britain, Germany, Japan, China and Taiwan regarding the legal integration of the shareholder derivative system, the legislative attitude of each country gradually moves from encouragement to containment. It is difficult for the government to intervene in the internal management of the company's top management, it cannot regulate everything. And direct litigation cannot be established because the transaction only harms the interests of the company, not the shareholders' personal interests directly, and the company is controlled by a controlling group that cannot file a lawsuit. At this time, both the duty of care and the duty of loyalty in corporate law are difficult to achieve through other systems. In order to protect the interests of shareholders, civil law countries such as Japan and China have transplanted and borrowed shareholder derivative litigations through legislation. Based on the process and results of the integration of China, Japan and the United States, this paper studies the main motivation and internal causes of shareholder derivative litigation in the process of legal transplantation and integration.

In general, shareholder derivative litigation has originated from Britain and the United States for more than 100 years of legal practice, but civil law countries such as Japan and China are late in the integration and the system is not yet perfect. In the process of economic globalization, trade not only circulates global goods, but also exchanges the commercial legal systems of various countries. However, the most important driving force is that with the development and prosperity of the company, small companies are gradually replaced by integration. When the

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company excessively pursues profits and damages the public interest, the law needs to actively regulate and adjust. At this time, the minority shareholders of the company need shareholder derivative litigation to protect their rights. Compared with the class action and representative action, the cost of the plaintiff of derivative action is extremely low, it is easy to launch, and can more effectively and timely deter the management.

There are two sides to everything, and shareholder derivative litigation has been accepted by other countries and the world at large for its unique advantages, such as private law autonomy, restraining corporate management, and helping governments reduce regulatory pressure. However, shareholder derivative litigation also has many drawbacks. For example, many of these interest disputes are nominally shareholders, but in fact they are dominated by lawyers. The compensation awarded to the company will always be inadequate because the attorney's fees can always consume one in practice. Finally, this system also often becomes a harassment type of litigation, which inhibits the business risk spirit of directors and managers.

3. Comparative Study of Shareholder Derivative Litigation

Due to the different judicial systems and legal cultures in each country, the above-mentioned disadvantages are also demonstrated in the process of legal integration of shareholder derivative litigation. Each country has different ways of seeking advantages and avoiding disadvantages, thus forming different modes of operation. The adjustment of the law to the company is governed by objective economic laws, and the integration of the law depends on the objective local market laws and judicial practice. The process of integrating shareholder derivative litigation in each country must serve the company's operation from the long-term development of society, rather than creating problems for the company, over-supervising the company, and instigating the relationship between the company's shareholders and the operator's executives. This article presents a comparative study of the shareholder derivative litigation systems in Japan, the United States and China, in combination with the current state of development of their market economies and judicial practices.

3.1. Security deposit

It is to prevent the system from being abused and not hinder the operation of the company to restrict shareholders from initiating derivative litigation by stipulating the number of shares held and the security deposit. Because of the different levels of economic development in each country and the different attitudes of the government towards shareholder derivative litigation, the amount of security deposit is also different. The security deposit is also closely related to the domestic security system.

The development of American shareholder derivative action system has also experienced two stages, from encouraging to curbing its abuse. The turning point of the two stages in the United States was in 1930, when the Business Investigation Commission led by Franklin Wood made a report that derivative litigation did more harm than good to companies, leading many states to try to control the wave of derivative litigation initiated by lawyers and minority shareholders. In 1944, Article 267 of the revised Company Law of the State of New York provided that if the shares held by the shareholders who initiated derivative litigations, the trust certificates of voting rights or the shares represented by the interests of beneficiaries were less than 5% of the total shares of any class issued by the company, and the market value was less than $50000, they should provide guarantee for litigation costs according to the request of the defendant and the order of the court. Subsequently, a number of other states have amended their corporate laws to increase the requirements for filing derivative litigation. In particular, when the derivative litigation is a class action, the cost of guarantee often exceeds ten million dollars, which needs to be paid by the litigation representative and the lawyer. Sometimes, the representative of action advances a portion of the cash or negotiable securities, and the

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insufficient amount is guaranteed by the lawyer or another person. If the case is lost, the representative and the lawyer bear the loss of litigation costs themselves, and the lawyer is not only unpaid, but is also liable for the loss of litigation costs and guarantee costs. This provision prevents litigation representatives and lawyers from colluding with each other to take advantage of class action to conduct indiscriminate litigation to a certain extent.

The United States requires a 5% holding or $50,000 in New York, 3% in Wisconsin and $25,000 in New Jersey. California and Texas require a plaintiff to deposit only if the court determines that the cause of action is insufficient. In contrast, there is not much judicial practice in civil law systems because the shareholder derivative system has just been born, and in 1993 the Japanese government wanted to promote shareholder derivative litigation to regulate the top management in companies with private power. In Japan, the fee for representative actions was reduced to 8,200 yen across the board and the object amount was set at 950,000 yen, resulting in a significant increase in litigation cases. Abuse of shareholder-derived lawsuits made it difficult for companies to operate properly. However, Korea has learned from this experience and set the object amount of litigation at 10 million won.

The amount of the security deposit is not only related to the government's attitude towards shareholder derivative litigation, but also related to the security system in this country. Article 267 of the Japanese Commercial Code provides that if a defendant in a shareholder derivative litigation requests and proves that the plaintiff is in bad faith, the court may order the plaintiff to provide equivalent securityat the defendant's request. Taiwan's company law also has similar provisions, and the defendant is exempted from the obligation to prove that the plaintiff has bad faith. From the actual situation in China, a court cannot order a plaintiff to provide security unless the defendant proves that the plaintiff brought the derivative litigation in bad faith. Since China has no tradition of the plaintiff providing guarantee to court, it is difficult to implement security deposit system in China. Japan's legislation distinguishes whether the plaintiff has malice, which is worth learning from China.

3.2. Status of the company

In the common law system, the principle established by the Solar City case of the Delaware Court of Chancery holds that a shareholder brings an action for the benefit of the corporation, and therefore he is not the true plaintiff, but only a nominal plaintiff in corporate law.In order for the judgment to be directly effective against the company, the plaintiff has the power to represent the company as long as the plaintiff who actually exercises his rights in the lawsuit does not conflict with the collective he represents in terms of interests and has a lawyer to exercise his duties. Therefore, the shareholders who actually exercise their power are regarded as the nominal defendants in the derivative litigation in the British and American countries to exercise their power instead of the companies that are the real plaintiffs.

In civil law systems, a company in a representative action is considered a plaintiff with the same interests as the shareholders of the plaintiff. Unlike in common law systems, it is up to the court to decide whether the company will participate in the litigation, depending on the specific circumstances of the case. Article 268(2) of the Japanese Commercial Code provides that a company may intervene in a lawsuit, except when it would delay the lawsuit or when the burden on the court is significantly greater. Paragraph 2 of Article 201 of the Civil Procedure Law of Japan stipulates that "a judgment that is determined for the benefit of another person who has acted as plaintiff or defendant shall also be effective for that other person", which is a new product of the organic fusion of shareholder derivative litigation with Japanese law. Japanese scholars believe that in order to give the company the opportunity to understand the process and outcome of the lawsuit. it is also necessary to pass a law that explicitly requires that the person bringing the lawsuit should inform the company of the facts of the lawsuit within the shortest possible time after filing the lawsuit. Only then when the company does not

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participate in the lawsuit, the company has the right to apply for a retrial if this judgment causes property damage to the company. In the common law system, there is no written law on this, as it would be superfluous to do so in England and the United States, where the system is relatively mature. Whenever a judgment offends the interests of a company, the company is bound to appeal. In the civil law system, in order to make the foreign system and the integration of their own laws, only need the regulation of statutory law, in order to achieve the ultimate goal of safeguarding the interests of the company and the interests of minority shareholders.

3.3. Special litigation committee

In common law systems, the task of the special litigation committee is to determine whether the company wants to accept the litigation and whether to terminate it. The members of the committee are directors who have no personal interest in the transaction challenged by the derivative litigation, as only such directors can be independent. Typically, these members are newly appointed directors specifically for the purpose of establishing a special litigation committee. They generally conclude that the litigation is not in the best interests of the company and should be terminated. Sometimes, such a conclusion appears reasonable. For example, the cost of litigation would exceed the potential recovery, or the litigation would have a greater adverse social impact on the company's business than the conduct it targets, etc. The special litigation committee is a system set up on top of the company's already well-established system in order to check and balance minority shareholders, which can be organized by the company's other management in order to file lawsuits. This system is also designed to prevent shareholder derivative litigation from being abused by lawyers or minority shareholders to the detriment of the company's interests.

The reason why the United States set up the special litigation committee is that the plaintiff subject of shareholder derivative litigation in the United States is very broad. China does not have such a system because there are very few well-constructed companies in China and the range of subjects that can file shareholder derivative litigation is very narrow, so there is little demand for such a system in China. This is also the case in Japan and Taiwan. Due to the restriction on the eligibility of defendants, unless the company decides to initiate a lawsuit to hold directors liable by itself, when the plaintiff shareholder requests the company to hold directors liable, the company's institution (the supervisor), after accepting the shareholder's request to initiate a derivative litigation, cannot terminate the derivative litigation after discussion even if it is deemed pointless to hold directors liable. In fact, Japan and Taiwan only consider the gross negligence of directors and others as the scope of pursuit in a derivative litigation, and in determining what constitutes gross negligence, it has itself gone through the process of commercial management judgment.

The Chinese Company Law does not set up a litigation dismissal system, which I believe is precisely the problem with the legislation of the Company Law in China. In the interests of the parties to be balanced in the litigation adopted an asymmetric system design, that is, the governance structure of the Chinese company is adopted by the Japanese and German for the body, the British and American for the real model, in the shareholders derived from the defendant's eligibility for litigation is adopted by the U.S. model of freedom, but in the dismissal system follows the practice of civil law countries, which is very likely to cause abusive litigation. It is recommended that a symmetrical system be chosen in our legislation: either the U.S.-style system of actionable acts, defendant qualifications and corresponding commercial business judgment principles and litigation dismissal, or the Japanese-German system of limiting liability. If the litigation dismissal system is adopted, the resolution may be made by disinterested directors and independent directors or by disinterested shareholders.

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3.4. Settlement of action

In the judicial system of the United States, settlement of action has always played an important role. The system of settlement of action is regulated in detail in the Federal Rules of Civil Procedure and can be summarized as follows: the court's duty to review, the notice procedure, and the hearing procedure. Settlement, as well as withdrawal of the lawsuit, must be agreed to by the court, and the court is required to review the request for termination of the lawsuit. Japan does not have a settlement of action system, and only section 266 of the Japanese Companies Act provides that when a shareholder brings a derivative litigation the plaintiff shareholder may settle with the defendant director. "The court shall notify the company of the settlement, and the company shall have the right to object to the settlement, provided that the objection is made within two weeks from the date of receipt of the notice. If the company does not object in writing within that period, the plaintiff shareholder shall be deemed to have settled with the defendant director, and the contents of the settlement shall refer to the relevant contents notified to the company by the court. "Japanese law provides that a plaintiff shareholder may reach a settlement with the defendant only with the approval of the court and also with the consent of all shareholders. Otherwise, no settlement can be made. In the U.S., instead of requiring the consent of all shareholders, it is sufficient to notify other shareholders and obtain the court's consent. As can be seen, the U.S. system of settlement of action is more detailed and more operational.

The Chinese Company Law does not provide for a system of settlement of action in shareholder derivative litigation, and from the perspective of protecting the rights and interests of the company and enhancing the efficiency of litigation, litigants should be permitted to settle. This is because there are few shareholder derivative litigation in China, and even fewer that seek to benefit from shareholder derivative litigation through settlement in bad faith, which is caused by practical factors and costs.

4. Conclusion

From the previous comparison, it can be seen that the United States has the most perfect shareholder derivative litigation system, and other countries, especially civil law systems, are not sufficient in their judicial practice because they are provided for directly in the company law by way of legislation. Only through a large number of judicial practices can this system collide and clash with different legal systems, and in the process, they influence and penetrate each other and adjust their own systems, and jointly promote the improvement of the system.

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