# Shareholder Suits as a Technique of Internalization and Control of Management

## A Functional and Comparative Analysis[1]

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### *I. Introduction*

Unfortunately, we do not live in the best of all corporate governance worlds. Hence, the control of management is an oft-discussed topic. Since the Enron and Royal Ahold N.V. debacles in particular, the topic has garnered attention in both the academic and popular press. From an economic perspective, there are three basic agency problems within a corporation: (1) the relationship between managers and shareholders; (2) the relationship between controlling shareholders and minority shareholders; and (3) the relationship between shareholders as a class and other corporate stakeholders, such as corporate creditors and employees.[2] This article deals primarily with the relationship between management and the shareholders of a corporation. Drawing on a comparative and a functional method, that is to say on an institutional economic perspective,[3] the German and the American systems are compared in light of how they respectively address control of management by the shareholders. Special attention is paid to shareholder suits as a technique of control and/or internalization. From an economic point of view, suits can be considered as an instrument to internalize externalities. Controlling and enforcing legal obligations including fiduciary duties of management is a public good for the collectivity of shareholders and stakeholders.[4] Some kinds of shareholders suits allow the bundling of atomistic individual interests and the

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[2] For the treatment of these three agency relationships in a comparative and functional, that is to say economic analysis: *Kraakman/Hansmann,* Chapter 2: Agency Problems and Legal Strategies, in K*raakman/Davies/Hansmann/Hertig/Hopt*, The Anatomy of Corporate Law: A Comparative and Functional Approach (forthcoming July 2003).

[3] For a theoretical treatment of the economic analysis in comparative law, see *van Aaken*, Vom Nutzen der ökonomischen Theorie des Rechts für die Rechtsvergleichung, In: Prinzipien der Rechtsvereinheitlichung. Weber, C. et. al. (Hrsg.), (2001), 125ff.

[4] Public goods (in contrast to private goods) are goods which are non-excludable and non-rival in consumption. Examples are street signs or clean air.

observance of diffuse or corporate interests on the part of the shareholders. Shareholder suits in most cases do not only foster control of legality but also internalization of infringed rights.[5] Whereas in administrative law, individual action is mainly seen as a technique of internalization of infringed rights, in corporate law, it is viewed as a means of control of management. Here, both functions of actions will be considered. To the extent that the shareholder enforces an individual right, enforcement activity is at first sight a private good. At the same time, though, the enforcement enhances the public interest in legality. Thus, a bundling of goals takes place. Shareholder suits are a legal governance strategy which comes into effect *ex post*, that is, after the management acted.[6] Nevertheless, the "threat potential" of actions may also take effect *ex ante* as managers can be expected to be rational in the sense that they anticipate the risk of future sanctions. The mere possibility of control provides incentives for the managers and can thus be expected to lead to an altogether lower level of negative externalities caused by managerial misbehavior.

Why can shareholders from a rational-choice perspective be expected to make infrequent use of shareholder suits? Do derivative suits, class action and popular suits (hereafter referred to as "mass-suits") make sense from an economic perspective? What kind of incentives are generated for the individual shareholder by such possibilities of action? How should it be evaluated from a normative standpoint that legal mechanisms are *de lege lata* such as to deter shareholder suits? What kind of costs and benefits do those legal mechanisms have on a societal level? If more shareholder suits are desirable, what kind of legal mechanisms should be suggested?

As a means of addressing such questions, this article first describes the problem (II.), then lines out the principal-agent-relationship between management and shareholders (III.), before going on to clarify the relevant concepts of rights, interests and externalities in jurisprudence and economics so that the economic concepts can be applied to the legal problem in consideration (IV). There, a framework is elaborated, which makes it possible to analyze "mass-suits" together in a meaningful sense. An outline of the American and the German approaches to shareholder suits is included. In the subsequent section, the economic rationale of "mass-suits" is analyzed by contemplating the incentive structure for individual shareholders to bring an action (V.). Those incentives differ, depending on whether a subjective right or just a collective/corporate interest is infringed, and depending on what the

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[5] Even in the legal literature it is accepted that in some cases shareholder suits foster not only internalization of rights but also objective control of legality. See e.g. the resolution I. E. 1. C. a) of the 63. Deutscher Juristentag in Leipzig 2000. Nevertheless, there was at the same time a resolution that to have standing, the individual shareholder must be infringed upon in a subjective right: Resolution I. E.2.

[6] See *Kraakman/Hansmann,* Chapter 2: Agency Problems, for the *ex post/ex ante* distinction.

procedural possibilities and costs of actions are in the given context. The German and the American system are analyzed from this perspective (VI.) and ways of avoiding abuse of action are suggested (VII.), while the ultimate section concludes.

## *II. Description of the Problem*

The essence of the agency problem between management and shareholders is the separation between management and capital or in other words between ownership and control.[7] The control of management may be external or internal. Internal control may be solely exercised by the shareholders in a monistic system, or by shareholders together with a supervisory board in a dualistic system. Whether management is sufficiently constrained by inside control has been hotly debated. External control by the state may be exercised by an administrative agency such as the Securities and Exchange Commission in the United States or the Federal Financial Services Supervisory Office[8] in Germany. According to what is known as the business judgment rule, external control institutions do exercise only a certain control of legality, but do not control expediency. External control may also be exercised by market forces, which work through the mechanism of "exit", not of "voice",[9] as shareholders may just sell their shares as a means of signaling their distrust in management.[10] Creditors might

[7] *Berle/Means*, The Modern Corporation and Private Property (1932). See also the seminal article by *Jensen/Meckling*, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure: The Journal Of Financial Economics 3 (1976) 305ff. For an overview of the principal-agent-problem see *Furubotn/Richter*, Institutions and Economic Theory: The Contribution of the New Institutional Economics (1998). The principal-agent problem deals with a situation in which one individual hires another to take some action for him as an "agent". There are two types of informational problems in this setting. Hidden action (moral hazard), that is the owners' inability to observe how the manager is working, and hidden information (asymmetric information), i.e. the managers' ability to possess superior information about the firm's opportunities.
The principal–agent-problem is characterized by moral hazard, which occurs when the agent acts on behalf of the principal, and is supposed to advance the principal's goals. Because the agent and principal have differing objectives, however, and because the principal cannot easily determine whether the agent's actions are actually self-interested misbehavior, moral hazard characterizes many principal-agent situations. Moral hazard is the form of postcontractual opportunism that arises because actions that have efficiency consequences are not freely observable (monitoring problem) so the person taking them may choose to pursue his or her private interests at others' expense.
Management members may pursue their own goals of status, high salaries, expensive perks, and job security rather than the stockholders' interests, may push sales growth over profits, may treat themselves to huge staffs and corporate jets, and may oppose takeovers that would oust them and increase the value of the firm.
[8] Sector Securities Supervisory/Asset – Management (Bundesanstalt für Finanzdienstleistungsaufsicht), § 4 WpHG. For a German – American comparison and overview of control by the state, see *Becker*, Verwaltungskontrolle durch Gesellschafterrechte: eine vergleichende Studie nach deutschem Verbandsrecht und dem amerikanischen Recht der corporation (1997), 39ff.
[9] See for these categories *Hirschman*, Exit, Voice and Loyalty: Responses to Decline in Firms, Organizations, and States (1972). Whereas the exit mechanism hints toward investor protection by capital markets regulation, the voice mechanism is dealt with in the corporate law.
[10] Control would then be exercised by a takeover market. Management is often ousted as a consequence of takeovers. The takeover market in Germany is much less active than in the US, however. Furthermore, the capital market has as rationale the efficient allocation of resources, whereas the internal control mechanisms are about legality of decisions of corporate organs.

just refuse to give credit. Internal and external control mechanisms are, of course, complementary, but the focus of this paper rests exclusively on the internal control initiated by shareholders.

In the aftermath of the Enron debacle and other corporate governance failures, the idea of attuning shareholders to the supervision and enforcement of the law is gaining ground. Nevertheless, since the seminal work of Berle and Means,[11] the passivity of shareholders is mostly taken for granted in economic literature. There are two interrelated problems: the divergence of interests between managers and shareholders (the agency problem) and the problems dispersed shareholders are facing in minimizing agency costs (the collective action problem[12]). The typical companies have grown so large that they must rely on many shareholders to raise capital.[13] The shareholders then face severe collective action problems in monitoring corporate managers. Each shareholder owns a small fraction of a company's stock, thus receiving only a fraction of the benefits of playing an active role, while bearing most of the costs. Passivity or rational ignorance serves each shareholder's self-interest, even if monitoring and control of the management promises collective gains – here, one may identify a typical public good problem.[14] Nevertheless, the problem of extortionate and frivolous suits ("strike suits") certainly exists and is much discussed in the legal literature.[15] This can be labeled a control paradox: on the one hand, economics predicts rational passivity and

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[11] *Berle/Means*, The Modern Corporation.

[12] See for the treatment of collective action problems *Olson*, The Logic of Collective Action (1965). Collective action problems arise if everybody would like to have a public good provided but it is cheaper for everybody to free-ride and wait until somebody else provides the good. Economists predict that in many circumstances the good will not be provided. See also *Bernard S. Black* , Shareholder Passivity Reexamined, Mich. L. Rev. 89 (1990), 520, 522f.: "Collective action problems, which arise because each shareholder owns a small fraction of a company's stock, explain why shareholders can't be expected to care. I will call this view the "passivity story….The passivity story assumes a benign legal environment." *Black* is concerned mainly with proxy rules as a means of empowering shareholders.

[13] See for the ownership structure in Germany e.g. *Goergen/Renneboog*, Why are the Levels of Control (so) Different in German and U.K. Companies? Evidence from Initial Public Offerings, in: Journal of Law, Economics, and Organization 19 (2003; forthcoming), now available: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=276287, 4: "When shareholder rights are not sufficiently protected or cannot easily enforced in court, shareholders may increase their control to levels that make them no longer vulnerable to expropriation or to levels that ensure large private benefits of control. … We expect a higher control concentration in Germany given the lower degree of shareholders rights."

[14] See for an analysis of the mitigation of that problem through institutional investors *Rock*, The Logic and (Uncertain) Significance of Institutional Shareholder Activism, in: Georgetown Law Journal 79 (1991), 445ff. and *Bernard S. Black*, Agents Watching Agents: The Promise of Institutional Investor Voice, UCLA L. Rev. 39 (1992), 811ff.

[15] See e.g. *Zöllner*, Kontrollrechte des einzelnen Aktionärs: Beschränkung, Erweiterung und Missbrauchsbekämpfung, ZGR Sonderheft 12 (1994), 147ff. and *Timm* (Ed.), Missbräuchliches Aktionärsverhalten (1990). For the US, see the Wood Report, which was prepared for the Chamber of Commerce of the State of New York, found that plaintiffs gained only 13 out of 573 derivative suits involving publicly held corporations. F. Wood, Survey and Report Regarding Stockholders' Derivative Suits 32 (1944). The Wood Report led to the adoption of "security for expenses" statutes designed to curb derivative litigation. For similar and more recent criticisms of the derivative action, see the Business Roundtable, Statement of the

indifference from shareholders, while on the other hand, there is much concern about costly strike suits with no utility to the corporation. In economic terms, an optimality problem presents itself: there is a need to find the institutions which prohibit meritless suits to be commenced, while encouraging legitimate claims to proceed.[16]

Generally speaking, legal errors can be divided into two categories. The first category of error is called type I error, or the "false positive", where meritless suits are allowed to be commenced, whereas type II errors, or "false negatives" keep legitimate claims out of court. In corporate litigation, the most discussed example of a false positive would be a shareholder suit which is launched with the sole purpose of extorting a sum of money from the corporation.[17] The threat potential of such suits can be very costly in terms of legal advice, time and foregone opportunities for the corporation. The problem is the initial uncertainty about the outcome of a law suit, resulting in threat power of the claimant. This uncertainty can produce frivolous suits, that is to say, suits the legal order *ex post* would not have wanted. Deterring suits, of course, can preempt suits that *ex post* would have been beneficial. Even if it is found that no perfect standard[18] can be devised that accurately separates strike suits from meritorious suits, it remains necessary to take into account that increasing the legal obstacles for bringing a shareholder suit will decrease Type I error, but will also increase Type II errors, that is, meritorious suits will not be brought. The costs of frivolous suits must therefore be weighed against the costs of insufficient control of corporate management and the infringement of shareholders' rights.[19] As shareholders' rights and their enforcement are even taken to be an explanatory variable for the value and broadness of capital markets and growth rates,[20] the potential economic costs of insufficient legal protection of shareholders seem to be

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Business Roundtable on the American Law Institute's Proposed "Principles of Corporate Governance and Structure" (1983); for a critique of the Wood-Report, see *Becker*, Verwaltungskontrolle, 230f.

[16] For an economic analysis of when it is in the corporate interest (i.e. augmenting corporate value) that a shareholder brings a derivative action, see *Kraakman/Park/Shavell*, When Are Shareholder Suits in Shareholder Interests?, in: Georgetown Law Journal 82 (1994), 1733ff.

[17] This may happen, for example, through abandonment of action or through settlement.

[18] Nevertheless, legal mechanisms exist which might asymmetrically deter frivolous suits. Those will be discussed below.

[19] See for this argument also *Stout*, Type I Error, Type II Error, and the Private Securities Litigation Reform Act, Ariz. L. Rev. 38 (1996), 711ff. arguing that the costs of Type I error are lesser than costs of Type II error.

[20] See *La Porta/Lopez-de-Silanes/Shleifer/Vishny*, Legal Determinants of External Finance: Journal of Finance 52 (1997), 1131ff. and *La Porta/Lopez-de-Silanes/Shleifer/Vishny*, Law and Finance: Journal of Political Economy 106 (1998), 1113ff.; hereinafter LLSV. They argue that the protection investors receive determines their readiness to finance firms, legal rules thus being critical to the development of a functioning capital market. Even though LLSV do an empirical analysis, the economic rationale behind the correlation can be easily explained by the markets of lemons paradigm in *Akerlof*, The Market for "Lemons": Qualitative Uncertainty and the Market Mechanism, Quarterly Journal of Economics 84 (1970), 488ff. Managerial fraud makes it difficult for investors to detect differences in the quality of the securities they buy, making it impossible for investors to distinguish between high quality and low quality shares. Under this theory, the market will be quickly flooded with bad firms, because fraud allows them to sell worthless securities at high prices. Until investors can distinguish between bad and good securities, they need to discount the quality of all the securities in the market.

high. In this paper, it is suggested that the abuse of a control right should not lead to its legal extinction but rather that one should examine how the incentives for strike suits could be altered, in such a way that the baby not be necessarily thrown out with the bath water.

*III. The Principal-Agent-Relationship between Shareholders and Management*

The principal-agent-framework used in economics is helpful in order to understand the structural relationships between the different players in corporate governance, especially the relationship between shareholders (the principal) and management (the agents). The players are – in the terminology of constitutional law[21] - the following: the *shareholders' meeting*,[22] which acts as the legislative body of a corporation, the *management* exercising the executive function and the *single shareholder* as citizen. German corporate law is based on a dualistic system with the supervisory board as yet another player, elected by shareholders and possibly by the employees in cases of co-determination.[23] The supervisory board in turn elects the management board, and is theoretically supposed to supervise it. Under the monistic American system, management is elected by the shareholders directly. As the German supervisory board does not have a legislative function, it qualifies as part of the executive. Therefore, it is possible in a first step to analyze the structure of the American and the German system together. The corporation as a distinct legal person has to be distinguished from the entirety of shareholders, as do other groups, such as creditors or employees who may also have a stake in the corporation. As a legal fiction, the corporation is not able to act by itself and is therefore left out of the analysis at this point. Nevertheless, it may be part of a judicial process if someone else (management or the shareholders) acts on its behalf.[24]

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Thus, they lose confidence in the market, and will no longer pay high prices even to good firms selling quality securities. If that happens, the good firms exit the market, as they cannot get a good price for the securities. The market therefore will be dominated by "lemons".

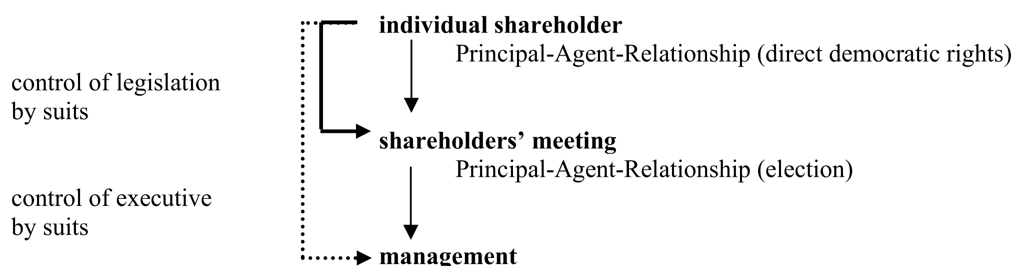
[21] In the legal and economic literature there is a long tradition of drawing an analogy between constitutional law and corporate law. See e.g. *Brondics*, Die Aktionärsklage (1988), 92 and *Karsten Schmidt*, Informationsrechte in Gesellschaften und Verbänden (1984), 13, *Steinmann*, "The Enterprise as a Political System," in Hopt/Teubner (eds.) Corporate Governance and Directors' Liabilities: Legal, Economic and Sociological Analyses on Corporate Social Responsibility (1985), 401; *Gifford*, A constitutional interpretation of the firm, Public Choice 68 (1991), 91ff. *Vanberg*, Organizations as Constitutional Systems, in: Constitutional Political Economy 3 (1992), 223ff. For a survey of the different concepts of corporations, see *Hill*, Visions and Revisions of the Shareholder, in: Am. J. Comp. L. 48 (2000), 39.

[22] Even though the shareholders' meeting can of course not act as an individual, for reasons of simplicity it is assumed to act as an organ.

[23] Under the Mitbestimmungsgesetz (Co-determination Act) of 1976, employees of corporations with over two thousand workers elect one-half of the supervisory board members. In smaller companies, employees elect one-third of the board members.

[24] Even if the idea of a corporation as an independent unit ("Unternehmen an sich") is not prevalent anymore, the idea of the interest of the corporation as a legal unity still is firmly grounded in German discussion. See *Baums/Scott*, Taking Shareholder Protection Seriously: Corporate Governance in the United States and in Germany, Paper prepared for the International Workshop on Corporate Governance, Saarbrücken, October, 15$^{th}$ 2002, 19 and *Lopez-de-Silanes*, The Politics of Legal Reform, G-24 Discussion Paper Series, No. 17, April 2002;

Furthermore, management is mostly supposed to act on behalf of the interest of the corporation, supposedly meaning not only the shareholders' interests but also the interests of all other stakeholders - with the exception of its own interest.[25] Again in analogy to constitutional terminology, corporate governance is a form of direct democracy, as the shareholders are the only body within a corporation with legislative powers.[26] The shareholders' meeting decides not only on the constitution of the corporation, i.e. the articles of incorporation, but also has to decide all essential questions. Figure 1 provides an overview of the principal-agent-relationship between shareholders and management.




Principal-Agent-Relationships in Corporate Law (Fig. 1)

It is sensible to formulate a chain of principal-agent-relationships as follows: management is elected by the shareholders' meeting and has the task of executing the articles of incorporation of the company and the law. Carrying out this executive function (with broad discretion concerning the business judgment) in turn affects the utility of a single shareholder and/or the "well-being" of the corporation. Managers do not always act according to their fiduciary duties. German and U.S. law enforce these duties through two underlying suppositions. First, individual shareholders are supposed to protect their interests by participation in the decision process on fundamental corporate issues (Legislation; fine arrow). In addition, shareholders can control management by election (fine arrow). [27]

Generally, it is possible to allow for individual control by shareholders not only of the legislative level through direct democratic rights (voting rights) and actions against legislative decisions (solid arrow), but also of the executive level. Control of the executive level, that is, management, may be exercised either by the shareholders' meeting by binding management through legislative decisions and elections or by single shareholders through actions initiating

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http://www.unctad.org/en/docs/pogdsmdpbg24d17.en.pdf, 17: "in the best interest of the company and the shareholders".

[25] For a discussion of which interests must be served by the management, see *Baums/Scott*, Taking Shareholder Protection Seriously, 2f.

[26] Shareholders may, if they delegate their voting powers to a proxy, render the system a representative one.

judicial review (dotted arrow). Focusing on the issue of the controlling competence, a single shareholder may thus either control the legislative body - the shareholders' meeting - by actions controlling for legality of legislative decisions, or the executive - the management - when carrying out the legislative provisions. Here, judicial review is restricted by business judgment. The main focus of corporate law *de lege lata* is the control of management through the shareholders' meeting. Furthermore, management control is usually carried out primarily by elections of the board, by a majority of shareholders. The right to elect management is the most significant right that shareholders of publicly traded corporations have when there is no large shareholder group. It means that the managers need the votes of these shareholders to be re-elected.[28] The idea of control of the management by a single shareholder through the initiation of judicial review of managerial behavior is neglected by the law, especially in Germany. As such, there is a control of the executive only by the legislative body, not by the single shareholder through the courts. The control of the management by actions brought by shareholders is viewed in this article as an alternative and complementary means of control. The possibility addressed is the kind of legal redress for damage to the corporation caused by management.

To grasp the differences in the individual cost-benefit-calculations of a shareholder to bring a suit, a further distinction has to be made between the individual suit to enforce subjective rights (perhaps in the form of a class action) and the so-called derivative suit where the shareholder initiates an action on behalf of the corporation – a case of representative action (*actio pro socio*). Thereby one focuses upon the substantive right which is brought to court (influencing the benefit side of the calculation). The substantive interest is to be distinguished from the possibility of procedural enforcement of the right (influencing the cost side of the calculation). In logical terms, the substantive right and the procedural conditions of its enforcement are independent.

The most commonly found combinations of substantive right/corporate interest and procedural enforcement shall be discussed in this article. In the legal literature, the legal mechanisms of class actions, derivative suits and popular suits, i.e. "mass suits", are vividly discussed.[29] The notion of "mass-suits" is retained, as opposed to that of individual suits.

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[27] Here, of course, for those decisions where only simple majority is required, no minority protection is granted.

[28] One would assume that given this shareholder power, managers would be concerned with their re-election and retention. But managers have control over corporate information and the corporation's proxy materials, which are produced at corporate expense.

[29] See *Koch*, Prozeßführung im öffentlichen Interesse. Rechtsvergleichende Entwicklungsbedingungen und Alternativen objektiver Rechtsdurchsetzung (1983), 80ff.; *Koch*, Kollektiver Rechtsschutz im Zivilprozeß. Die Class Action des amerikanischen Rechts und deutsche Reformprobleme (1976); *Koch*, Alternativen zum

First, subjective rights may be enforced by an individual action (two-party law suit), yet they may also be enforced by a class action (multi-party suit, the US case). Thereby, an individual brings an action defending an individual right but simultaneously gathers in principle all the individuals concerned so that individual rights of all class members are enforced. Second, it is possible to enforce objective law[30] by an individual action (popular suit). Third, it is possible to enforce the right of a legal entity by an individual suit of a shareholder as a representative (derivative suit). In this case, an action might be brought by an individual (the case in the US) or may need some kind of quorum of the shareholders as a requirement for initiation (the case in Germany).

### *IV. Rights, Interests, Right of Action and Externalities: a Legal – Economic Comparison*

The concepts used by lawyers and economists tend to differ. In particular, the notion of public or corporate interest (*bonum commune*) is normally not mentioned together with utility or externality. The connection between these notions is analyzed hereunder as a means of clarifying the interrelation between internalization, rights and actions.

#### *1. The Economic Notion of Utility and Externality*

The notions of utility and externality are everyday notions in economic parlance. What is their connection to legally protected interests? The economic notion of utility is defined in a strictly subjective manner. This notion allows to capture all interests independently of the legal system in force, that is, rights as well as collective respectively diffuse[31] or corporate interests including interests which are not at all legally protected. It includes for example notions as profit expectations which are not legally protected in general. Externalities are those consequences of decisions or actions which affect other persons than the decision-maker, without the former being compensated (if it is a negative externality) or without these persons having to compensate the decision-maker (if it is a positive externality). Those consequences will thus not be taken into account by the decision-maker as she is not affected by them.

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Zweiparteiensystem im Zivilprozeß, in: KritV (1989), 232ff.; and *Hass*, Die Gruppenklage: Wege zur prozessualen Bewältigung von Massenschäden (1996).

[30] By "objective law" a notion is meant which captures all law regardless of if a subjective right is infringed upon. In constitutional law, for example, state organization is objective law, whereas basic rights are subjective law (and objective law).

[31] The notion of diffuse interest was generated by *Cappelletti,* Access to Justice. A Comparative General Report, RabelsZ 40 (1976) 669ff., S. 680: "Diffuse interests are collective or fragmented interests such as that in clear air or the enforcement of consumers protection measures. The basic problem they present – the reason for their diffuseness – is that either no one has a right to remedy the infringement of a collective interest or the stake of any one individual in remedying the infringement is too small to induce him to seek enforcement action."

Externalities are important in economics because they may lead to inefficiency. Because the producers of externalities do not have an incentive to take into account the effect of their actions on others, the outcome will be inefficient. There will be too much activity that causes negative externalities, and not enough activity that creates positive externalities, relative to an optimal outcome. For example, the cost borne by others when an industry pollutes a river would be referred to as an externality. External effects are produced because property rights (including the competencies of management) might be insufficiently defined[32] or because transactions costs[33] (including monitoring costs[34]) are too high. They occur also in principal-agent-relationships. In the context under consideration here, the existence of positive transaction costs means that there is a type of organizational failure. Management may cause externalities within the principal-agent-relationship by exceeding its powers or acting out of self-interest, disregarding shareholders´ interests.

To internalize externalities – making the polluter pay, for example, or making the management act in shareholders' interests - three conditions must be met: (i) well specified property rights must be defined, (ii) there must be the freedom to exchange these property rights and (iii) transactions costs should not be higher than the mutual benefit of the potential transaction. Nevertheless, there are some externalities which are extremely difficult to internalize in principal-agent-relationships, especially in the context under consideration here. First, the duties of management are necessarily not clearly defined due to indeterminate legal terms and due to the business judgment rule.[35] Second, as corporate law is to a large extent *ius cogens*, there is generally no autonomy of the parties to specify other rights than those explicitly provided for in the law of corporations. Statutes of incorporation, for example, cannot allow for a representative right of single shareholders on behalf of the corporation, if

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For the problem of organizing collective interests see also *Olson*, The Logic of Collective Action: Public Goods and the Theory of Groups (1971).

[32] *Baums/Scott*, Taking Shareholder Protection Seriously, 27f. state as follows: "The public interest theory of the board is that its members will legal and moral obligations out of a sense of selfless duty and internalized norms. It would help of course if those legal and moral obligations were better defined and generally agreed on, instead of having a large degree of ambiguity and uncertainty about whose interests are to be served. But in any case directors will possess substantial discretion, so their personal incentives must also be given attention." Therefore, we can assume that the Coase-theorem will not apply; see *Coase*, The Problem of Social Costs, in: Journal of Law and Economics 3 (1960) 1ff.

[33] Transactions costs were first analyzed by *Coase*, The Nature of the Firm: in Economica 4 (1937), 386ff. Transactions costs are all costs one incurs if carrying out a transaction. In order to carry out a market transaction it is necessary to discover who it is that one wishes to deal with, to conduct negotiations leading up to a bargain, to draw up the contract, to undertake the inspection needed to make sure that the terms of the contract are being observed, and so on. More succinctly, transaction costs include: search and information costs, bargaining and decision costs as well as policing and enforcement costs.

[34] If the firm is viewed upon as an entity of relational contracts, costs of principal-agent-relationships are contractual costs.

the law does not allow for it. Third, there are interests which, while being stated in the law or in the articles of incorporation, are not formulated in law as a subjective right. Enforcement of provisions such as the legality of behavior of management or avoiding overly high remuneration of directors, have the character of a public good and do not give an individual right to the individual shareholder – and thus no right to sue. Even though shareholders' (diffuse) interests, that is to say the interests of those affected, might be infringed by non-observance, there is no direct legal means of internalization by bringing a suit. Nevertheless, the individual contribution to enforcement can have large positive externalities for the other shareholders. As the utility of a successful suit is distributed among all shareholders, this amounts to the private production of a public good.

How can negative externalities produced by management behavior be treated? Should there be a corresponding procedural provision of action for those affected? *De lege lata* it is undisputed that the management has to act in a legal way irrespective of the economic rationale behind a decision. Diffuse interests are thus accounted for, but only by the law as such, without giving the individual shareholder a right to enforce it – if a subjective right is not infringed at the same time. Apart from internalization through the market, internalization may also happen qua law (e.g. taxes) or statutes of incorporation, qua a management decision or qua a court decision. Internalization by a court judgment remains the focus here, as it corrects the management decision which causes the externalities. Thus, if the court rules that the disputed behavior has to be revoked or has to be refrained from, this is one form of internalization. Equally, the restitution of damages, either to the corporation or to the single shareholder, is a form of internalization. The possibility to sue is as such one strategy of internalization – if the claimed outcome is then ordered by the court. In a first step, one has to clarify which legal provisions are objective law in the sense that it has to be respected by the management or the shareholders' meeting, and which legal provisions give a subjective right to the shareholders. Only in the second step, can one then ask for the procedural means of enforcement. To clarify the concept, figure 2 illustrates this distinction.

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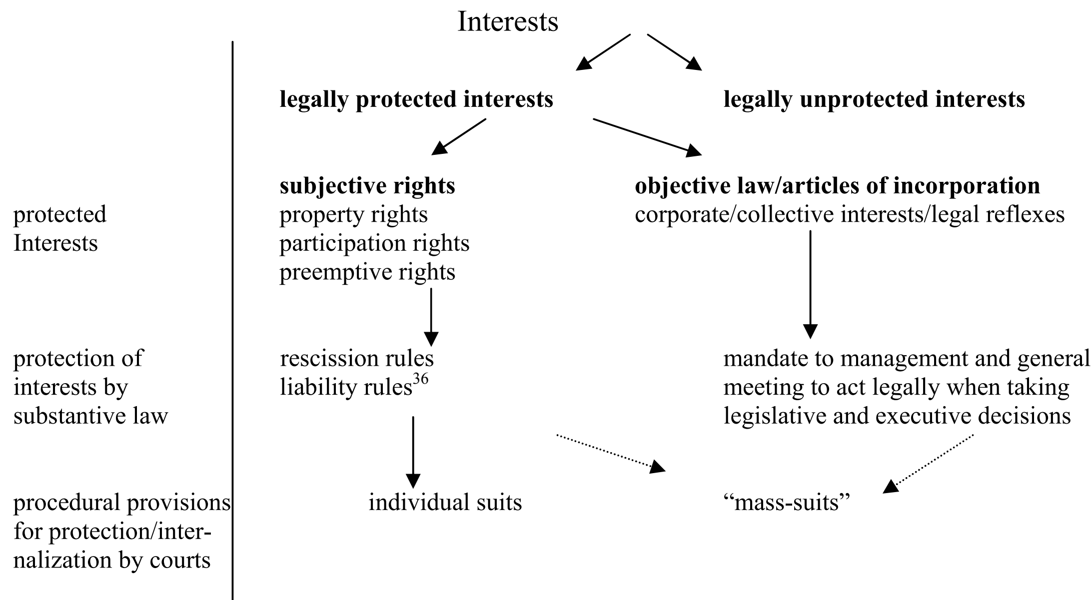
[35] Even if the legal texts would be formulated as precise as possible, indetermination of terms cannot be removed. This necessarily leads to discretion of management. Irrespective of this theoretical problem, non-discretion of management is not desirable. The problem is rather accountability.




Enforcement of Interests (Fig. 2)

*2. Legally protected Interests: subjective rights and collective interests*

Having examined the concept of externality, one may consider the possibilities of subjective rights and collective/corporate interests and their protection in the given legal systems.

a) The German approach

In German law, the main legal remedy of a single shareholder is the action of rescission of a decision of the shareholders' meeting or the action of nullity of the same body.[37] This type of action is also called the "popular suit" of shareholders,[38] as a subjective right of the shareholder does not need to be infringed, rather it allows for the control of legality (legality concerning the law and the articles of incorporation) of the decisions taken. There is thus a focus on the control of the legislative power of the corporation. Concerning the control of the executive, i.e. management, German law, contrary to US law, relies heavily on the control of the management by a supervisory board, rather than taking up the idea of the individual

[36] See for this distinction the seminal article of *Calabresi/Melamed*, Property Rules, Liability Rules, and Inalienability: One View of the Cathedral. In: Harvard Law Review 85 (1972), 1089ff.

[37] §§ 241ff. AktG (Stock Corporation Act). Individual rights may also be enforced by individual legal action concerning the right to information, § 132 Abs. 2 AktG. The same applies for affiliated companies in §§ 291 ff. AktG.

[38] First named popular suit by *Horrwitz*, Das Recht der Generalversammlungen der Aktiengesellschaft und Kommanditgesellschaften auf Aktien (1913), 88. See also *Schindler/Witzel*, Bedarf es einer neuen gesetzlichen Regelung des Anfechtungsrechts zur Bekämpfung räuberischer Aktionäre?: NZG 13 (2001), 577ff., 578 with further references.

shareholder as a private attorney general.[39] The extension of competence of control is viewed skeptically due to possibility of abuse,[40] but may be judged as being underdeveloped as more and more discretionary power is (*de facto*) given to the management without accordingly adjusting the means of control.[41]

Furthermore, in the German legal tradition, the difference between subjective right and collective interest as a general rule determines simultaneously which rights and interests are enforceable in court and which ones are not, in the sense that if there is a subjective right, there is also standing; if there is only a violation of a corporate interest or of objective law by management (in contrast to a violation by the shareholders´ meeting), no standing is granted for the individual shareholder. Within the corporate law literature it is debated which rights and claims are individual ones and which ones are claims on behalf of the corporation – which then gives no individual right to take action. Nevertheless, it is possible to draw an overview over the rights attributed to the shareholders. First of all, one has to distinguish between rights vis-à-vis the legislature, i.e. control of the shareholders' meeting, and rights vis-à-vis the executive, i.e. control of the supervisory board and the management board.

Even though the focus of this article is the control of management, in German law the control of the shareholders' meeting by the individual shareholder is viewed as an indirect means of control of the executive.[42] Therefore, the *control of the legislative level* by shareholders is shortly discussed. Here, actions by shareholders may be divided into two general categories (1) individual rights/individual actions and (2) minority rights/quorum actions. Individual rights (and therefore standing) are, for example, the right of rescission (Beschlussanfechtungsklage) and the preemptive right to new issues.[43] Minority rights are defined as those rights of control where not an individual shareholder with one share may exercise the right, but a certain percentage or a certain absolute amount of nominal capital is needed. They include the right of calling a shareholders' meeting and the right to complement

[39] See instead of many *Schulz-Gardyan*, Die sogenannte Aktionärsklage (1991), 16f. and *Brondics*, Die Aktionärsklage, 42 with reference to the reform of the corporate law 1937, which redistributed the powers within the corporation to the management. The shareholders' meeting is described as a "dethroned king".

[40] E.g. BGH 22.5.1989 =ZIP 1989, 980 (Kochs Adler).

[41] See also *Becker*, Verwaltungskontrolle, 65.

[42] As stated in § 119 AktG, the shareholders' meeting has the following responsibilities: Election of the shareholders' representative in the supervisory board; appropriation of distributable profits; ratification of the acts of the members of the management and the supervisory board; appointment of external auditors; amendments of articles of incorporation; measures to increase or reduce the share capital; appointment of auditors for the examination of matters in connection with the formation or the management of the company; dissolution of the corporation; transformation of the corporation (e.g. merger); consent to agreements between enterprises. Matter of management may only be decided by the shareholders' meeting, if the management so demands (§119 (2) AktG).

[43] § 186 (3) AktG.

the agenda.[44] Use of all these rights amounts to the private production of a public good, as when the measure is taken, utility is not excludable from other shareholders.[45] A more detailed look at the individual rights reveals that the individual shareholder has the subjective right of rescission and a right of action of nullity to redress defects of the decision of the shareholders' meeting.[46] If the court decides in favor of the plaintiffs, with *res iudicata* the decision takes effect *ipso iure*. In case of success, the decision of the shareholders' meeting is *ipso iure* nullified.[47] Thus, even if a single shareholder sues, the decision takes effect *erga omnes* (public good). The action has to be brought against the corporation rather than against its organs, such as the shareholders' meeting or the management.[48] The single shareholder has standing only if he was present at the shareholders' meeting.[49] He further has the subjective right to disclosure and the right to sue, if disclosure was not granted.[50] The right embraces all information on the corporation necessary to assess the agenda of the shareholders' meeting. The right of disclosure is restricted to issues of concern to the shareholders' meeting.[51] To enforce the right *de facto*, the right of rescission of a decision of the meeting is possible if disclosure was not granted. In addition, the shareholder may separately sue for disclosure before he takes an action of rescission, § 132 AktG.

In theory, control of internal transactions of the corporation has also to be carried out by the supervisory board,[52] which is elected by shareholders and in some cases employees. The shareholders' meeting may nevertheless decide with simple majority that a special auditor for due diligence has to be appointed.[53] With this decision, the appointment takes immediate effect – the only case in which the shareholders' meeting acts as a legal agent of the corporation. The appointee is supposed to throw light on internal transactions and gathers information for future decisions of the shareholders. In the event that a majority is not found

[44] A quorum of 5% of nominal capital is needed for the calling the shareholders' meeting, § 122 (1) AktG, which is essentially the task of the management board; § 121 (2) AktG. The same is needed for influencing the issues discussed at the shareholders' meeting, § 122 (2) AktG. If the management does not comply, an action may be brought by the minority shareholders to enforce the demand, § 122 (3) AktG.
[45] See explicitly so § 248 (1) 1 AktG.
[46] §§ 241-257 AktG. The grounds of action of rescission are stated in § 243 AktG (violation of the law or of the statues of corporation; decision benefiting unjustifiedly one or more shareholders over the rest), with special grounds in § 251 (Election of the supervisory board), § 254 AktG (Proposal on the allocation of the unappropriated profits), § 257 AktG (decision of the annual financial statements).
[47] The period of filing this suit is one month , § 246 (1) AktG.
[48] § 246 (2) AktG. This is especially in cases of variation of nominal capital.
[49] § 245 Nr. 1 AktG. He also has the right to sue if he was not present in case the notice of the meeting was improper, if he was incorrectly denied access to the meeting or if the decision was not properly published, § 245 Nr. 2 AktG. In the case of § 243 (2) AktG, every shareholder has the right to sue, no matter if she was present at the shareholders' meeting, thus enforcing minority rights.
[50] §§ 131, 132 AktG.
[51] See for a discussion of the informational right see *Grüner*, Zeitliche Einschränkung des Rede- und Fragerechts auf Hauptversammlungen, in: NZG (2000), 770ff.
[52] § 111 AktG.

for this, the danger that illegal behavior of management is not discovered becomes aggravated. Minority shareholders in particular are not capable to audit internal transactions without sufficient information. They would therefore also refrain from claiming damages or asking to bring a suit according to § 147 AktG. Therefore, a minority holding 10% or 1 million Euro of nominal capital may ask a court to appoint a special auditor for due diligence.[54]

We now turn to the control of the executive level. According to German law, the supervisory board is not only the organ destined to supervise and control the (legality of behavior of the) management board but also has this as its primary task.[55] Direct control of the legality of behavior of management by a single shareholder is generally not possible in German law. Nevertheless, directors (management board and supervisory board) are liable vis-à-vis the corporation if they violate their duties, which are stated in the law,[56] in the articles of incorporation, and in their contracts. The enforcement of these duties is – as a matter of management/business policy – normally to be carried out by the management board. The management decides by discretion if a claim is to be brought.[57] Only if a claim against a sitting member of the management board is in question, the management board is substituted by the supervisory board as an agent for bringing the claim.[58] If there are actions to be brought to enforce liability against the board or a member of it, this action has to be brought by the supervisory board representing the corporation. The problem of possible failure of the law in the books, i.e. possible collusion between management board and supervisory board or simple inaction by the supervisory board, is taken care of by the law in the way that if the shareholders' meeting decides with simple majority that a claim has to be brought or if a minority holding 10% of nominal capital demands an action, the organs of the corporation have to comply.[59] The petition can be made only in the shareholders' meeting. § 147 (1) 2 AktG requires "contemporaneous ownership" of the minority shareholders of three month minimum before the shareholders meeting. A representative agent to bring the action may be appointed by a court, if a minority holding 10% or 1 million Euro of nominal capital so

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[53] § 142 (1) AktG.

[54] § 142 (2) AktG.

[55] § 111 Abs. 1 AktG. In the literature it is argued that this excludes at the same time the supervision possibilities of shareholders as this would disturb the order of competencies within the corporation, see instead of many *Brondics*, Die Aktionärsklage, 106f., 125f. There is no stringent argument behind that kind of reasoning.

[56] §§ 76 (1), 83, 90, 92, 93, 111, 117 AktG. In conducting business, the members of the management board have to employ the care of a diligent and conscientious manager, § 93 AktG. § 93 (2) AktG states that members of the board of directors who violate their duties are liable vis-à-vis the corporation for the damage caused. In case it is disputed, if they acted in due care, the burden of proof is theirs, i.e. from a damage of the corporation a violation of the subjective and objective standard of duty of care is deduced, if not proven otherwise.

[57] This reminds of the business judgment rule in derivative action cases in US- law.

[58] § 112 AktG.

petitions in order to avoid the sitting management or supervisory board to bring the claim (conflict of interest).[60] If there is no such demand according to § 147 (1) AktG by the shareholders, a court – upon request of shareholders owning 5% or 500.000 Euro of nominal capital - may still decide to appoint a representative agent, if facts are presented which arouse strong suspicion of fraud or gross illegal behavior causing damage to the corporation. This provision seeks the possibility of sanctioning illegal behavior by the management which is not objected to by the majority of shareholders and is thus a protection of minority shareholders.

Damage claims against the directors might be brought, if shareholders or third parties influence their decisions in an impermissible way, thereby inflicting damages on the corporation. The claim has to be brought on behalf of the corporation.[61] To enforce the action, shareholders again must turn to § 147 AktG. Nevertheless, an individual shareholder may also sue individually, if the damage was directly inflicted upon him.[62] To substantiate the damage, a loss in the market value of the shares is not enough, as this would only reflect the damage done to the corporation itself. There is one exception to the rule that the individual shareholder may not sue on behalf of the corporation – a derivative action in the law of affiliated companies.[63] The shareholder of the dependent company may take legal action against the management of the controlling company on behalf of the dependent company.[64] In other words, the quorum right of appointing a representative agent of § 147 AktG is substituted by the right of individual action of the shareholder in affiliated companies.

In short: German law – contrary to US law - still focuses on control of the legislative level by shareholders, thereby creating a gap in the legal protection of investors as the *application* of the law and the articles of incorporation by the management cannot be controlled by individual shareholders. This principle is upheld even though - due to the business judgment rule (managerial discretion) - courts control only for legality, not for business expediency. However, danger only partially stems from faulty decisions of shareholders' meetings; most of the times it comes from factual actions and decisions of management. The focus on legislative control is especially problematic, if violation of the law is committed by a refusal or omission of a decision of the shareholders' meeting - as then there is no legislative

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[59] § 147 (1) AktG.

[60] See also the catalogue of measures by the German government (Press release Nr. 10/03 of February, 25th 2003, where it is proposed to change § 147 AktG, lowering the minimum requirement of nominal capital of shareholders from 10% to 1% (or from 1 million Euro to 100.000 Euro of nominal capital) to enforce an action.

[61] § 117 (1) 1 AktG.

[62] § 117 (1) 2 AktG

[63] Third book of the AktG.

[64] § 319 (4) AktG, § 310 (4) AktG. The same right applies accordingly in factual groups (faktischer Konzern), §§ 317 (4), 318 (4) AktG, that is, groups in which there is a dominant corporation without formal contract of domination or merger.

decision to be disputed. [65] There is no control for so-called factual changes brought about in the articles of incorporation (faktische Satzungsänderung[66]). If the claims of the corporation are not enforced or not enforced with sufficient vigor, shareholders may not take action. Only in the case of damage claims against the management, a quorum of shareholders may appoint a representative agent to enforce the right of the corporation. Rather, it is only an initiative to have someone else bring an action. In autonomous corporations, the individual shareholder has no right of individual action against the management on behalf of the corporation. Whether the supervisory board is a sufficient organ of control is debatable. It seems that supervision by the board may be *de facto* insufficient due to personal ties between management and supervisory board. If the supervisory board brings an action against management it will be indirectly accusing itself in many cases. Thus, the supervisory board's interest of enforcing the law against the management board is not high. Therefore, actions for damages by the supervisory board against management are rare.[67] Furthermore, the minority rights of control are a form of attenuated individual rights which raise the costs of bringing a claim by creating collective action problems. As there is a quorum needed for some actions to be brought, the individual shareholder might either be deprived of that right, if she does not own enough shares to comply with the quorum, or she does face immense costs of gathering enough other shareholders to exercise the minority right.[68]

b) The US-American Approach

Corporate law in the United States, especially regulations dealing with the internal affairs of corporations, is basically state law.[69] Nevertheless, for the purposes of this article it is possible to give an overview of the most important issues that are common to US corporate law irrespective of state boundaries. Under traditional corporate structure, control of a

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[65] Admittedly, the distinction between legislative powers and executive powers is not easily drawn. The general scheme is for ordinary business decisions to be made by the board while certain structural and governance decisions are for the shareholders and sometimes with the board. We may nevertheless assume that all essential decisions have to be decided by the shareholders meeting. See for Germany BHGZ 83, 122 = NJW 1982, 1703 "Holzmüller". The court stated the corporation has to turn to the shareholders' meeting for business policy decisions, if the decision in question encroaches profoundly upon the shareholders' rights of association or capital interests. Again, the judgment thereby lies with management. The significance of this decision concerning an *actio pro socio* is heavily discussed. For the different arguments see for example *von Gerkan*, Die Gesellschafterklage, in: ZGR (1988), 441ff.

[66] See for this notion *Karsten Schmidt*, Gesellschaftsrecht (1986), 484, Footnote 184.

[67] See *Thomas Raiser*, Recht der Kapitalgesellschaften (1983), § 12 II 1. See also *Baums/Scott*, Taking Shareholder Protection Seriously, 20.

[68] For a critique of the effectiveness of this institution, see also *Brondics*, Die Aktionärsklage, 58; *Schwark*, Anlegerschutz durch Wirtschaftsrecht (1979), 143 with further literature.

[69] Nevertheless, there are common features, or at least rules that apply to the majority of states, many of the states relying on the Revised Model Business Corporation Act. The RMBCA is a product of the Committee on

corporation is vested in a board of directors elected by the shareholders. These directors choose in turn the officers who run the business. Shareholders generally can vote on the election of directors, amendments to the articles of incorporation[70] and certificate and certain major structural issues such as mergers, liquidations and sale of substantially all of the assets of the corporation.[71] The right to elect directors is the most significant right of shareholders in publicly traded corporations.[72] Directors are elected at each annual shareholders' meeting unless otherwise provided in the articles of incorporation.[73] This relatively short tenure allows for direct control of the management by annual elections (*ex ante* control mechanism).[74] Here, an important means of control of management is the proxy fight. The proxy fight usually involves a shareholder group nominating their own slate of directors to replace current management by seeking the votes of shareholders.[75]

In addition to the power to vote, shareholders are granted the right to receive information under both federal securities laws and state law. Statutes granting the right of inspection are liberally construed, and courts generally will permit an inspection provided that shareholders

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Corporate Laws of the Section of Business Law of the American Bar Association, issued in 1984 and amended several times.

[70] Depending on the articles of incorporation, shareholders may also vote on the by-laws. Nevertheless, in many corporations, the by-laws are decided upon by the directors. This has the advantage that no special majority of shareholders and no submission to the government is needed. Thus, transaction costs are spared. Yet, this amounts to a factual deprivation of traditional shareholders' legislative rights as more and more important decisions may be formulated in the by-laws, thereby depleting the corporations constitution: the statues of incorporation.

[71] There are other mandatory state law provisions, such as the requirement of annual reports, the regulation of the issuance of shares, restrictions on indemnification, and establishment of fiduciary duties. All states mandate that shareholders be provided the opportunity to hold annual and special meetings. One way in which shareholders can legitimately protect their interest in the corporation is by demanding a shareholders' meeting. But even if shareholders can ratify fundamental corporate decisions, they are powerless to initiate them. Routine matters of corporate policy fall within the exclusive province of the board's authority to "manage" the corporation, see e.g. E.g., DGCL §141(a).

[72] See *Pinto*, Corporate Governance: Monitoring the Board of Directors in American Corporations, Am. J. Comp. L. 46 (1998), 317 and *Kraakman/Hansmann,* Chapter 3: The Basic Governance Structure, in K*raakman/Davies/Hansmann/Hertig/Hopt*, The Anatomy of Corporate Law: A Comparative and Functional Approach (forthcoming July 2003).

[73] RMBCA § 8.05 (b). Many jurisdictions allow firms to stagger the terms of office for the directors so that continuity of corporate policy by preventing the entire board from being elected at the same time is assured.

[74] See in contrast the maximal and de facto general term length of 5 years in Germany, § 84 (1) AktG. See also *Kraakman/Hansmann,* Chapter 3: The Basic Governance Structure, for a discussion of proxy solicitation and influence on shareholders power.

[75] State law deals primarily with the mechanics of the voting process. It determines voting rights, dates and notice of the meetings and the use of proxies. Proxy fights are also significantly influenced by the proxy rules issued under the Securities Exchange Act of 1934. Under the rules, the shareholders must be provided with a proxy statement which requires full disclosure concerning the vote. In addition to the specific requirements of the SEC rules, there is also a general rule against fraud and misleading statements in a proxy contest. Failure to comply with the rules may result in an action by the SEC or a private cause of action by shareholder. Nevertheless, parties desiring to engage in a proxy fight face the rational apathy problem of shareholders and the reluctance of large institutions to vote against the managers. The incumbents have the advantage of control of corporate information and use of corporate assets including reimbursement for the costs of the battle. Insurgents have to convince the shareholders to change directors with the uncertainty of their management and must usually

have proper purposes for seeking to inspect particular corporate documents.[76] An important monitoring device that protects shareholders is the requirement of full disclosure to the shareholders on issues of significance. Disclosure is mandated by both fiduciary duty and federal securities law. Disclosure informs shareholders about their investment and can inform the shareholders that the managers are acting adversely to shareholder interests.

With respect to means of control of management by legal action, suits by shareholders may be divided into three general categories (1) derivative actions, (2) individual actions, and (3) representative actions or class actions. Whereas an individual suit is the correct form of action when an individual right of the shareholder is infringed directly by a breach of duty of management, the derivative suit is brought by a single shareholder on behalf of the corporation. Class actions concern not the question of whose rights are infringed, but rather the procedural question of how a suit may be brought. Each of these three possibilities shall subsequently be discussed.

It is not always easy to tell whether an action is derivative or direct.[77] As a rule, a shareholders' derivative action is an action brought by one or more shareholders to remedy or prevent a wrong against the corporation. Such an action is distinguishable from an action for a direct wrong to an individual shareholder or a group of shareholders. Often, the same set of facts can give rise to both direct and derivative claims. Courts have discretion to determine whether an action is derivative or direct.[78] A shareholder may individually sue corporate directors when he has sustained a loss separate and distinct from that of the other shareholders – just as in Germany. He also has the right to seek redress from other shareholders, such as majority shareholders,[79] to vindicate a personal right, as distinguished from a corporate right. However, an individual shareholder has no right to bring an action in his own name and on his own behalf for a wrong committed solely against the corporation. Thus, as a general rule,

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bear the costs of their fight. Unsuccessful insurgents are not entitled to reimbursement for their proxy expenses. For details, see *Pinto*, Corporate Governance, 336f.

[76] For an overview of rights to disclosure of the individual shareholder, see *Landis*, What Corporate Documents are Subject to Shareholders' Right to Inspection., 88 A.L.R.3d 663 (updated 2002). The information which has to be disclosed is broader than in Germany, including right of inspection of the lists of shareholders, share registers, stock or transfer books, and the like; the right to inspect the minutes of corporate proceedings; the right of shareholders to inspect books of account and other similar financial records; and the right of shareholders to inspect proxies held and ballots cast in an election for the corporate board as well as the proxy statements.

[77] See e.g. Abelow v. Symonds, 156 A.2d 416, 420 (Del. Ch. 1959): "(T)he line of distinction between derivative suits and those brought for the enforcement of personal rights asserted on behalf of a class of stockholders is often a narrow one, the latter type of actions being designed to enforce common rights running against plaintiffs' own corporation or those dominating it, while the former are clearly for the purpose of remedying wrongs to the corporation itself."

[78] See e.g., Hanson v. Kake Tribal Corp., 939 P.2d 1320 (Alaska 1997): looking at the adequacy of the remedies under derivative and direct actions.

wrongs which affect the corporation itself or the shareholders generally, give rise to causes of action on the part of the corporation, and not primarily of an individual shareholder.[80] Neither a single stockholder nor any number of stockholders can sue the corporate directors or officers at law on their own behalf for damages for fraud, embezzlement, malfeasance, or gross negligence whereby the property of the corporation is wasted and the stockholders are deprived of dividends or their shares are depreciated or rendered valueless. In such a suit, the shareholder acts for the corporation in seeking damages or restitution of corporate property and the suit is therefore derivative in nature.[81] A shareholder has no personal right against a director for a wrong or an injury to the corporation, even though the particular wrong or injury may have resulted in the destruction or depreciation of the value of her share[82] - identical solutions concerning the question of substantive right may be found in the US and in Germany. Generally, it is only when a stockholder alleges that certain wrongs have been committed by the corporation as a direct fraud upon the stockholder, and such wrongs do not affect other stockholders, that he can maintain a direct action in his individual name.[83] This action may or may not take the form of a class action,[84] as shall now be discussed.

Class action[85] is an action based upon individual rights belonging to each member of the class. The need for class action arises when the parties are too numerous to be joined. One party or a few are being permitted to sue on behalf of all, but claiming nevertheless the infringement of individual rights.[86] It favors the resolution of broadly held grievances and the

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[79] Under state law, when a controlling shareholder unfairly uses their control of the board of directors to benefit themselves, not only are the directors liable but the controlling shareholders are as well. See Zahn v. Transamerica Corp., 162 F.2d 36 (3rd Cir. 1947).

[80] E.g. if a majority stockholder receives dividends which he knows are not paid *pro rata* to all stockholders, aggrieved stockholders may bring only bring a derivative action to have the dividends wrongfully paid restored to the corporation.

[81] See Knapp v Bankers Secur. Corp. (CA3 Pa) 230 F2d 717 (applying Pennsylvania law).

[82] See Funk v Spalding, 74 Ariz 219, 246 P2d 184; Sears v Hotchkiss, 25 Conn 171; Greenwood v Greenblatt, 173 Ga 551, 161 SE 135; Smith v Poor, 40 Me 415; Waller v Waller, 187 Md 185, 49 A2d 449; Smith v Hurd, 53 Mass 371; Seitz v Michel, 148 Minn. In 19 Am Jur 2d Corporations § 2266 the arguments for this kind of restriction are stated: "The reason for this is that at law the directors and officers are the agents of the corporation and not of the stockholders; and besides, if one stockholder could sue at law, there might be as many actions as there are stockholders. Another important Consideration is that the injury done to the capital stock by wasting, impairing, and diminishing its value is not, in the first instance, or necessarily, a damage to the stockholder. All sums which can in any form be recovered on the ground are assets of the corporation, and when collected and received by directors, receivers, or any other persons entitled to receive the same, they are held in trust primarily to pay the debts of the corporation; and it is only after these debts are paid and in case any surplus remains that the stockholders are entitled to receive anything".

[83] Green v Bradley Constr., Inc. (Ala) 431 So 2d 1226.

[84] The right of a litigant to employ FR Civ P 23 as the provision for class actions in Federal Courts is a procedural right only being a rule of procedure and not a limitation upon jurisdiction. That is, FR Civ P 23 does not abridge, enlarge, or modify any substantive right or alter basic jurisdictional requirements.

[85] See *Silver*, Class Actions -- Representative Proceedings, in: Bouckaert/De Geest (Eds.), Encyclopedia of Law and Economics, Volume V (2000), 194.

[86] FR Civ P 23 has as its roots practical considerations of efficiency in courts and fairness to participants. Although there are certain differences between the typical class action and a shareholder derivative action, it is

redress or deterrence of wrongdoing by means of civil litigation not otherwise economically feasible on an individual basis.[87] A representative plaintiff can file an action and seek class certification, which has several prerequisites. Rule 23(a) of Federal Rules of Civil Procedure (FR Civ P) states as follows: One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class. The plaintiff and counsel for the plaintiff who sues as a class representative take on additional responsibilities. Of primary importance are the energy and time expended in litigating the threshold questions as to whether the case is suitable for class relief and, if so, what kind of notice to the class members is required. The task of the class representative is further complicated by the greater control the court will exercise over the conduct of the case and by the limitations on the freedom to settle.[88]

Let us now turn to derivative actions. Defining derivative actions, one must distinguish between two causes of action: it is one action to compel the corporation to sue and it is another action brought by a shareholder on behalf of the corporation against those liable to it to redress harm to the corporation. A derivative action allows shareholders to monitor and

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well established that a shareholder derivative action is closely allied to class actions generally, since in the usual shareholder derivative action the plaintiff brings suit as the representative of a group or class of minority shareholders. In keeping with this view, original Rule 23 of the Federal Rules of Civil Procedure, as promulgated in 1938, treated the shareholder derivative action as a part of class actions. The class action was an invention of equity mothered by the practical necessity of providing a procedural device so that mere numbers would not disable large groups of individuals, united in interests, from enforcing their rights. Class action and derivative suits are partially functionally equivalent.

[87] As stated in 32B Am Jur 2d Federal Courts § 1782, the "aggregation of individual claims in the context of a classwide suit is an evolutionary response to the problem of injuries unremedied by the regulatory action of government. Where it is not economically feasible to obtain relief within the traditional framework of a multiplicity of small individual suits for damages, aggrieved persons may be without any effective redress unless they may employ the class-action device. Although there is a potential for misuse of the device, with persons other than class members becoming the chief beneficiaries of the class action, the remedy for abuses lies not in denying the relief sought in a particular action, but in re-examining FR Civ P 23 as to untoward consequences."

[88] FR Civ P 23(e) provides as follows: "Dismissal or Compromise. A class action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to all members of the class in such manner as the court directs."

One of the aims of the notice provision of Rule 23(e) is to protect class members from prejudice by informing those members of the class who may have refrained from pursuing their individual claims for relief in reliance on the suit brought by the class representative; thus, prohibiting dismissal or compromise of a class action without notice to the class permits intervention by interested members of the class. Another policy served by the notice provision of Rule 23(e) is the reduction of frivolous class allegations appended solely to strengthen the bargaining power of the named representative and enhance the settlement possibilities of his individual claim. Thus, the rule was aimed at curbing extortionate "strike suits," in which defendants may be willing to pay a premium settlement to "buy-off" the named plaintiffs, in compromise of their individual claims, for the elimination of the potentially more damaging class claim. This led to the requirement of notice, pursuant to Rule 23(e), to class members of all class action settlements. It is recognized that the notice provision of Rule 23(e) is mandatory and applies to all class actions once class certification has been obtained.

redress harm to the corporation caused by management, in the event that management fails or outright refuses to redress the harm. For the present purposes, it is enough to point out that the derivative suit is also the correct action if the corporation suffered harm by the decisions or actions of the management.[89] The action is derivative when brought by a shareholder on behalf of the corporation for harm suffered by all shareholders in common.[90] There are several standing requirements which are addressed briefly. Most states and FR Civ P 23.1[91] require a plaintiff to be a shareholder of the corporation at the time a derivative action is filed and at the time of the challenged transaction. The second requirement is often referred to as the "contemporaneous ownership" requirement.[92] This requirement is designed to curtail strike suits by prohibiting potential plaintiffs from buying into a lawsuit or commencing a derivative action by simply purchasing shares after the alleged wrong has occurred.[93] The size of plaintiff's financial stake in the corporation is immaterial – contrary to the German framework, where the equivalent situation stated at § 147 AktG requires a quorum for an action to be initiated. The only time a plaintiff's financial stake may be of consequence is where state law provides security-for-expenses, which might *de facto* privilege large

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[89] See Meyer v. Fleming, 327 U.S. 161, 167 (1946): "the purpose of the derivative action [is] to place in the hands of the individual shareholder a means to protect the interest of the corporation from the misfeasance and malfeasance of 'faithless directors and mangers".

[90] Lewis v. Knutson, 699 F.2d 230, 237-38 (5th Cir. 1983): "When an officer, director, or controlling shareholder breaches [a] fiduciary duty to the corporation, the shareholder has no 'standing to bring [a] civil action at law against faithless directors and managers,' because the corporation and not the shareholder suffers the injury[; e]quity, however, allow[s] him to step into the corporation's shoes and to seek in its right the restitution he could not demand on his own."

[91] Fed R Civ P 23.1. for derivative actions by shareholders states that: "In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which the plaintiff complains or that the plaintiff's share or membership thereafter devolved on the plaintiff by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for the plaintiff's failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs."

[92] Several state statutes provide exceptions to the contemporaneous ownership rule. Factors used to determine whether the exception should apply include: (1) whether there is a strong *prima facie* case in favor of the claim; (2) whether a similar action has or is likely to be commenced; (3) whether the shareholder acquired shares in the corporation before public disclosure of the alleged misconduct; (4) whether the defendant(s) will be permitted to retain ill-gotten gains if the suit does not go forward; and (5) whether the suit, if successful, will result in unjust enrichment to the shareholder. There are several doctrines to determine if an exception to the contemporaneous ownership rule: Under the continuing wrong doctrine, the contemporaneous ownership requirement will not apply where the alleged wrong was continuing at the time the shareholder bought stock even if the wrong began before the shareholder purchased the stock. However, not all courts allow a plaintiff to allege a continuing wrong to overcome the contemporaneous ownership rule.

[93] See, e.g., Brambles USA, Inc. v. Blocker, 731 F. Supp. 643 (D. Del. 1990); In re Penn Cent. Transp. Co., 341 F. Supp. 845 (E.D. Pa. 1972).

shareholders and thus indirectly require a quorum.[94] Another important standing requirement is that of the demand requirement. As a derivative action redresses harm to the corporation, there is a presumption that the corporation, through its directors and officers, controls the decision to pursue a claim on behalf of the company. Accordingly, a shareholder wishing to maintain a derivative action must attempt to secure corporate action through a demand to the board that it initiate the litigation. To satisfy the demand requirement, the demand typically must (1) identify the alleged wrongdoers; (2) describe the factual basis for the allegations; (3) describe the harm caused to the corporation; and (4) describe the request for relief.[95] There are certain circumstances where a demand will be excused. Most courts recognize a futility exception to the demand requirement. FR Civ P 23.1 requires a shareholder who fails to make a pre-suit demand to plead with particularity reasons why a demand was not made. The plaintiff bears the burden of showing that a demand would be futile.[96] If demand was necessary and has been made, the board can decide whether to pursue the litigation, resolve the grievance short of litigation, or reject the demand. The board assumes control of the litigation if it accepts the demand. Frequently, the board of directors will reject a shareholders demand as not being in the best interest of the corporation. This is the most likely scenario, especially, if the wrongdoer is part of the management. If, follwing board rejection of a demand, a shareholder decides to move forward with the suit, the shareholder must prove that the board's decision to reject the demand was wrongful. To show that a board's decision to reject the demand was wrongful, a shareholder must overcome the presumption that the board acted in good faith, with due care and in the honest belief that the action taken was in the best interest of the corporation. This sequence calls into play the business judgment rule.[97] The business judgment rule determines when a shareholder may bring a derivative action after a

[94] States that have adopted security-for-expenses statutes include Arizona, California, Colorado, Florida, Nebraska, New Jersey, New York, Pennsylvania, and Wisconsin.

[95] 19 Am. Jur. 2d Corporations § 2273.

[96] There are several tests applied whether demand futility has been adequately pled. In Delaware, for demand to be excused, a shareholder must allege facts that if taken as true raise a reasonable doubt that (1) a majority of the directors are disinterested and independent or (2) the challenged transaction was otherwise "the product of a valid business judgment." (Aronson v. Lewis, 473 A.2d at 805). In New York a plaintiff must allege with particularity that (1) a majority of the directors is interested in the challenged transaction; (2) the board of directors did not fully inform themselves to the extent reasonably appropriate under the circumstances; or (3) the challenged transaction was so egregious on its face that it could not have been the product of a sound business judgment. The principal difference between the New York and Delaware tests are the degree of certainty with which a plaintiff must allege demand futility. See 19 Am. Jur. 2d Corporations § 2279.

[97] Under the business judgment rule, a court will not interfere with the judgment of a board of directors unless there is a finding of gross and palpable overreaching. A board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose. A court under such circumstances will not substitute its own notions of what is or is not sound business judgment.

demand has been rejected.[98] The business judgment rule provides that absent evidence of bad faith, fraud or lack of due care, courts will defer to the business judgment of corporate directors. In most circumstances, the business judgment rule places the burden on the party challenging the board decision to introduce evidence that the board either lacked good faith, acted in self-interest, or acted without due care. Absent a showing that the directors failed to meet their fiduciary obligations, the business judgment rule shields directors from personal liability. Successful wrongful refusal claims tend to involve allegations that the business judgment rule does not apply to a board's decision to reject a demand because either the board lacked due care or did not demonstrate good faith in reviewing and responding to a derivative demand. Even if the derivative action proceeds, the business judgment rule can come into play to determine whether liability exists for the underlying transaction if the latter involved a decision by the board.[99] The control of management through judicial review is thus limited to legality. A huge part of business policy is not reviewed. Internalization through courts thus takes place only in a limited sense. Furthermore, if a derivative suit succeeds, any recovery goes to the corporation, while the shareholder (or his attorney) receives legal fees from the company.

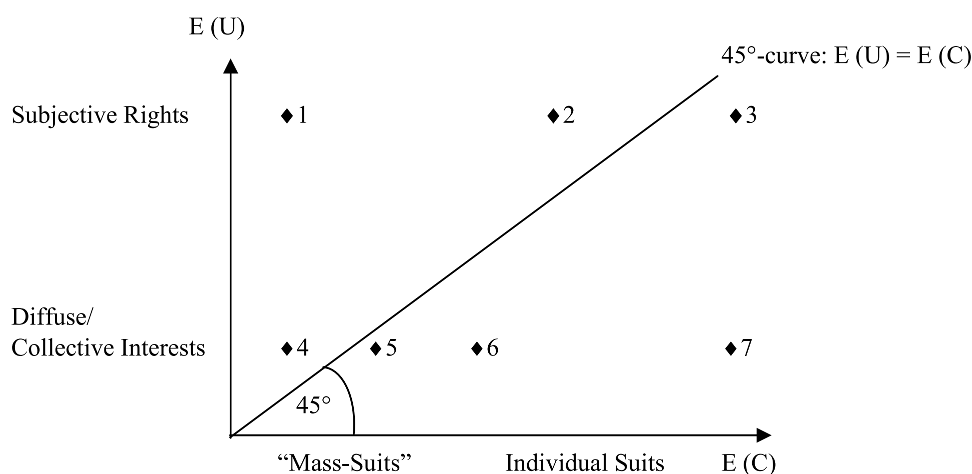
*V. The Economic Rationale for "Mass-Suits" in Corporate Law*

As spelled out above, the infringement of a subjective right in principle corresponds with an individual suit. If collective/corporate interests or objective law are infringed by the management, it is only the shareholders' meeting or (in Germany) the supervisory board that is acting on behalf of those affected, including the affected shareholders. However it is, of course, conceivable that the possibilities of control and action remain upon the shoulders of the principal, that is, the shareholder. Control of management may be improved by allowing those who are directly affected the possibility of having their claim reviewed by the courts. From an economic point of view, it is not deemed satisfactory to look only at legal provisions; rather it is also necessary to analyze in detail the factual incentive structures of launching suits in the first place. "Mass-suits", in particular the class action, are perceived as a device to empower individuals by affording them access to internalization/justice by courts.

[98] Zapata Corp., 430 A.2d at 784 n.10.

[99] Aronson, 473 A.2d at 812: "The function of the business judgment rule is of paramount significance in the context of a derivative action. It comes into play in several ways - in addressing a demand, in the determination of demand futility, in efforts by independent disinterested directors to dismiss the action as inimical to the corporation's best interests, and generally, as a defense to the merits of the [underlying] suit."

The individual incentives to control management by launching suits can be identified theoretically by assuming rational behavior of the individual.[100] The utility of the individual in launching a suit is narrowly defined as individual utility of internalization. Additional utility an individual may enjoy by – at the same time - providing a public good such as the legality of managerial behavior or by setting a precedent is neglected.[101] At first, we will consider the incentive structure of the individual varying with the procedural possibilities, as represented in figure 3:




**Incentive Structure of the Individual (Fig. 3)**

E (U) = Expected Utility of Action

E (C) = Expected Costs of Action

Point 1: Class Action

Point 2/3: Individual Action

Point 3/7: Quorum Action initially

Point 6: Quorum Action after Quorum is formed

Point 7: Derivative Suit/Suit against Shareholders' meeting controlling Legality

1. The incentive structure without litigation costs de *lege lata*

The incentive structure represents that of an assumed average individual, but as utility is defined subjectively, whether the individual shareholder will sue or not depends on subjective individual loss of utility. The preference intensity of the individual may thus make an important difference, as shall be explained in detail for the derivative suit, the class action,

[100] It is not disputed that other than rational considerations may play a role in bringing a suit. However, this does not apply for the average plaintiff, who is primarily relevant for the legislation. Extortionate suits may also be quite rational. For simplicity, it is assumed that the plaintiff is risk-neutral; would she be risk-averse or risk-seeking, the curve would be convex respectively concave.

and the action of rescission against a shareholders' meeting decision (popular suit). This specific incentive structure varies in accordance with the amount of shares an individual holds in the corporation. The more shares are owned by one individual, the more important is the expected individual gain for that same individual. The individual calculation thus depends upon the number of shares held. The argument presented in the figure applies to individual shareholders holding only a small number of shares in a public corporation. Other special interests such as those by shareholders who are simultaneously workers, clients or part of cross-ownership are neglected. Nevertheless, the argument will be true in principle if the number of shares hold by the respective individual is increased. Generally, it may be assumed that the larger the number of shares hold, the more the points depicted in figure 3 shift upwards, that is to say the expected utility of a suit will increase due to the possible higher benefit.[102] The expected costs will not increase accordingly but slower as the costs include a huge block of fix costs.[103] Furthermore, the expected net utility of a trial is subjectively estimated. Individuals may be bounded rational in calculating the probability of winning a suit. From behavioral economics it is known that under certain circumstances people are overoptimistic and under other circumstances loss aversion is eminent.[104] There may thus be a selection effect between those who have standing and those who actually sue.

The expected costs of the suit are displayed on the x-axis, whereas the expected utility is depicted on the y-axis. An individual will sue if and only if the expected net utility is positive, that is to say at all points above the 45°-curve. At all points below the 45°-curve, an action will not be brought.[105] Thus, a shareholder will sue only if his cost of doing so is less than his expected benefit from a suit.[106] The plaintiff's expected benefits also involve possible settlement payments or gains from trial, but all side-payments are neglected. However, for the current purposes, it is enough to focus on the trial gains, as questions of settlement shall be discussed below. From this description, one can note that a suit is more likely to be brought,

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[101] In the literature, this is often called non-altruistic behavior, that means only utility which is directly reaped by the individual counts.

[102] Note, however, that large shareholders may have other and more subtle ways of influencing management, possibly to the detriment of small shareholders. This latter problem could be overcome, for example, by a shareholders movement or associations for the protection of small shareholders.

[103] Depending on the cost regime, the court charges start always with a minimum and augment on a diminishing scale. The same holds in principle true for lawyers´ fees.

[104] See *Tversky/Kahneman,* Loss Aversion in Riskless Choice: A Reference Dependent Model, Quarterly Journal of Economics 106 (1991), 1039ff.; *Kahneman/Knetsch,/Thaler*, Experimental Tests of the Endowment Effect and the Coase Theorem, Journal of Political Economy 98 (1990), 1325ff.; *Kahneman/Tversky*, Prospect Theory: An Analysis of Decision under Risk, Econometrica 47 (1979), 263ff.

[105] Note that with a larger bundle of shares, the points being situated below the 45°-curve may shift above it, thus leading to a positive expected net utility.

[106] For a general economic analysis on litigation, see *Shavell*, Foundations of Economic Analysis of Law (forthcoming 2003), Chapter 17. http://www.law.harvard.edu/programs/olin_center/papers/404_shavell.htm.

(i) the lower the cost of a suit, (ii) the greater the likelihood of winning a trial and (iii) the greater the plaintiffs award provided he wins.[107] The award upon winning is defined by the utility derived from the internalization by the court, being the utility created by the court decision in favor of the plaintiff, that is to say the outcome of the trial is specified as the subjective evaluation of redress in the case at hand. The greater the infringed interest is, that is, the greater the externality, the greater will be the utility of the internalization.[108] If a suit is brought on behalf of the corporation or the court decision takes effect *inter omnes*, the shareholder enjoys the corporation's net gains from litigation only in proportion to his ownership interest, as the utility is calculated *pro rata*. The externality can be the infringement of a subjective right as well as in the violation of objective law or collective interests, if these are viewed as attenuated rights. Utility therefore originates either from respecting a subjective right or by respecting collective interests. It is assumed here that the infringement of a subjective right of the shareholder is a stronger impairment than the non-observance of a collective interest. This is plausible as the subjective rights of the shareholder are normally those which are the essence of his affiliation rights, such as the right to vote or the preemptive rights. However, of course, this does not imply that infringements of subjective rights always lead to a positive *net* utility of a suit – on the contrary. To lower the costs and thus augment the net utility is exactly the rationale of class actions in the US. The same reasoning applies, therefore, for negligible individual infringements and for non-observance of collective interests. Utility is thus a continuum.

The expected costs of an individual plaintiff are typically higher for individual suits than for group litigation, as the individual has to bear all costs – material and immaterial - alone in the former situation. Immaterial costs begin with the search for legal advice,[109] and problems of communication for the lay shareholder; they do not stop with the time lost due to such a process. The material costs can be divided in costs of the shareholder’s lawyer, costs of the adversary’s lawyer, and fees of the court. One also need distinguish from those three the *initial* costs of bringing a suit (pre-trial costs), such as the costs of a demand on the board for derivative suits (US), and the costs of finding concurring shareholders if the action legally requires a quorum of shareholders (Germany). In the latter case, increasing the quorum leads to simultaneous cost increase. The expected costs of trial then are a function of the expected outcome of the trial, if the costs are allocated due to the outcome of the trial. Generally

[107] A more formal presentation concerning utility would look as follows: E (U) = f (amount of shares, outcome, likeliness to win).
[108] The strength of infringement depends on the amount of shares held and on the kind of interest infringed.
[109] This is certainly true for the individual suits, but in class action cases the initiative to sue might be taken by a law firm.

speaking, without looking at the effects of the different cost allocation rules in the US and in Germany, costs will be higher in individual suits because costs are not shared between different plaintiffs and because one can assume that in group litigation the financial power and the experience and or quality of the law firms hired are greater. The expected costs of the suit vary according to the different allocation rules. Costs are therefore also a continuum. We shall have a closer look at the US and the German systems of cost allocation and their respective consequences for the individual incentive structure in a subsequent section.

At that point, the different incentives of the individual will be scrutinized in detail on the basis of the points depicted in figure 3. If subjective rights of an individual are infringed, it will be *ceteris paribus* more apt to sue as when a diffuse interest is infringed, since the loss of utility is assumed to be greater if a subjective right is infringed and thus the utility gain from an expected internalization by the court decision will also be correspondingly greater (points 1, 2 and 3). Furthermore, in an *individual suit*, the court decision is generally a private good, as the suit takes effect only *inter partes* and thus all gains (except for setting a precedent and providing for legality of management) by internalization are reaped by the individual. In this case, only where the individual expects costs to be very high, the individual will not sue (point 3). In contrast, if the claim is about a collective or diffuse interest, the court decision is a public good, as there are a huge number of individuals affected. There are huge incentive obstacles to provide a public good, as the individual, if he does has not have a very high preference for the good, will be inclined to take the position of a free rider and wait for others to provide the public good (points 5, 6 and 7). This is especially true for *derivative suits*, as the shareholder sues on behalf of the corporation (point 6 and 7). Even if a suit is successful, the utility is not privatized, but is collectivized for the benefit of the corporation, i.e. for all other shareholders and stakeholders. The public good provided is thus enlarged to all the stakeholders of the corporation, such as employees and creditors. The share of utility of the plaintiff is thus further diminished in derivative suits. As the shareholder has to pass the initial hurdle of demand on the board and may even have to go through a court decision, the initial costs of bringing a suit are elevated (point 7). Still, even if this hurdle is surmounted, the expected net utility is low, as it is the corporation and not the individual who launches the action who will reap the benefits in the event of success (point 6). It is thus rather unlikely that an individual shareholder will sue on behalf of the corporation on rational grounds.[110]

[110] Note that with increasing shareholdings of one individual this argument becomes weaker.

If the costs of the suit are high, one can expect that an individual suit will not be brought (point 7).[111] In contrast, if the costs of a suit are abated through the possibility of a "mass-suit", including a class action, the probability of a suit being launched rises (point 4). Class actions are more effective than alternatives, such as joinders or intervention.[112] Even though joinders, intervention or a common place of jurisdiction[113] have an effect in the same direction, they are not as effective as class actions because the joinders and individuals in an intervention still act individually in court and the court decision generally takes effect *inter partes*.[114]

Regarding quorum actions, that is, actions which can be brought only if shareholders who hold a certain quota of nominal capital and act together to bring an action, one has to differentiate between initial costs of gathering the other shareholders for bringing a suit (pre-trial costs) and the general costs as described above. The initial hurdle for being able to bring an action is very high in the beginning and excludes small shareholders[115] – unless they find some form of cooperation, which is difficult due to collective action problems and informational problems, as in public corporations shareholders do not know each other (point 7 or point 3, if a quorum is also required by law for an action concerning the infringement of subjective rights).[116] Once a group of shareholders forms the quorum to bring a suit though,

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[111] For example, if the managers of the company are stealing 100 Euro, yet it will cost 150 Euro to bring a derivative suit, then the shareholder will do nothing because the costs of recovery exceed the benefit. A rational profit maximizer will not spend the money. Even if it were to cost 50 Euro to avoid losing 100 Euro, choosing not to act may still be justified by a shareholder's "rational apathy". Although the benefits exceed the cost, a rational profit maximizer would rather let someone else, particularly a larger shareholder, enforce rights on their behalf and thus "free-riding".

[112] For Germany see § 59 - 63 ZPO. In US law there are also alternatives considered to class action. When the class is not large, joinder of all members as named parties may be more practical. Consolidation, stay, and transfer provisions, along with the traditional doctrines of *res judicata* and collateral estoppel, may also be available to avert parallel litigation involving the same questions of fact or law. However, bringing large numbers of additional parties in by this method would be very costly. Organizing the conduct of litigation with large numbers of additional parties is very tedious. The organizer, moreover, would have no effective way of obtaining reimbursement from other plaintiffs for these costs. For a broad discussion, see *Rosenberg*, Avoiding Duplicative Litigation of similar claims: The Superiority of Class Action vs. Collateral Estoppel vs. Standard Claims Market, Discussion Paper No. 394 of the John M. Olin Center for Law, Economics, and Business, Harvard Law School (2002), http://www.law.harvard.edu/programs/olin_center/papers/394_rosenberg.htm.

[113] Such is the suggestion of *Baums* (Ed.), Bericht der Regierungskommission Corporate Governance (2001), 190. See also *Heß*, Sammelklagen im Kapitalmarktrecht, AG 3 (2003), 113ff., 122.

[114] Under German law the suits are – even in intervention - as a rule independent from each other. The action of one plaintiff-shareholder does not affect those of others, § 61, 64 ZPO. Not only the lengths and the chosen attorney may differ, also the decision of the court may differ, *res iudicata* and appeals are independent. Nevertheless, intervention may help the court in collecting common facts and parties are free to choose a common lawyer. Normally, the costs are incurred per capita, § 100 I ZPO.

[115] Quorum actions, thought as a minority right, do thus have the opposite effect: they attenuate the rights of individual shareholders.

[116] This problem is debated concerning proxy votes and the duty of management to give information of the other shareholders.

the costs decrease compared with an individual suit, as the costs are shared among those bringing the suit.[117]

Holding the infringement of an interest or right equal, it may thus be concluded that if there is a legal provision for "mass-suits", the probability of a suit is greater, as the expected net utility of a "mass-suit" is rising because of the lower expected costs (compare points 1 and 2 with point 3 for subjective rights and points 4, 5, 6 and 7 for collective interests). In other words, the individual will, if the expected costs are held equal, be more apt to sue if a subjective right is infringed than if a collective or corporate interest is at stake, as the utility gain compared with the *status quo ante* is greater. This is clarified by the comparison between point 1 and 5 on the one hand and point 2 and 6, 7 on the other. At the respective latter point, a suit will not be brought, as those are denoting collective interests, which will not be claimed in court if there is only the possibility of a individual suit. This would be different where the law allows for a possibility of "mass-suits": the latter increases the probability of court control of non-observance of collective interests (see point 4).

To summarize: "mass-suits" diminish the *de iure* and *de facto* hurdles which are an obstacle to effective control of management through the shareholders. The rational indifference of the shareholder concerning internalization and control of legality of management is mitigated through these legal mechanisms. From a rational-choice point of view, shareholder suits can be expected to be few, especially in those cases where they provide a public good. Nevertheless, as explained above, a more credible threat of litigation may not always be better, as frivolous suits may be encouraged, if no legal mechanisms are in place to separate meritorious from frivolous suits. This problem will be dealt with further below.

2. The incentive structure with litigation costs *de lege lata*

If litigation costs in Germany and the US are taken into account, the picture depicted above changes.[118] In Germany, the general principle holds that the losing party bears all the costs (so called "English Rule"), i.e. the fees of its own lawyer, the fees of the other party's lawyer and

[117] Graphically, this could be shown in a coordinate plane, depicting on the x-axis the number required for a quorum and on the y-axis the costs for the initiating individual. Whereas the costs for the initiating individual will rise up to the quorum, it will fall once the required number of shareholder is gathered. The course of the curve will differ, depending how difficult it is for the individual to gather other shareholders willing to act. This partly depends on the law, as in the accessability of other shareholders and the possibility of obtaining information about them.

[118] The differences in remuneration of attorneys will not be discussed here due to space restrictions. They may well make a difference in the calculation of a potential plaintiff. Contingent fee arrangements thus lower the expected costs in case of failure under the American rule, while also lowering the expected utility in case of success, as the fees may amount up to about 30% of the value of the claim. This arrangement is conducive to risk-averse plaintiffs.

the charges of the court.[119] If there is a fee-shifting regime as under the English Rule, the expected costs of an action are nil if the plaintiff succeeds. The costs depend upon the value of the claim. There are some provisions concerning either the duty to bear the costs or the value of the claim in the Stock Corporation Act. For example, the risk of launching an action is mitigated in cases of action of rescission by the individual shareholder. In that case, the value of the claim is generally set at a maximum level of 10% of the nominal capital of the corporation.[120] If the value of the claim is more valuable than that to the plaintiff, the value may also be set higher or – if the plaintiff is not economically capable to bear the fees, they may be reduced.[121] Furthermore, if the court appoints a special representative for due diligence (i.e. the shareholders' request was successful), the corporation has to bear the costs for the representative and the charges of the court.[122] In the case of a successful action being brought to call a shareholders' meeting, the corporation pays the cost of the meeting and the litigation costs.[123] Where a disclosure action is brought, the charges of the court are reduced to two times the full charge, whereas it is generally three times the full charge.[124] The value of the claim constitutes, as a rule, 5000,- Euro.[125] Where a complaint is filed against the composition of the supervisory board, the value of the claim is four times the full charge, that is to say, higher than the normal charge. The value of the claim is set at 50.000 Euro. In principle, the corporation has to bear the costs, but the judge may also shift the costs based on equity considerations.[126]

The described rules apply to individual suits, in which the shareholder is supposed to exercise a personal right of affiliation. With the exception of a complaint against the composition of the supervisory board, the expected costs from action are mitigated or shifted to the corporation in case a representative is appointed by the court. The expected costs from trial are therefore mitigated. The individual will therefore be more prone to sue. In all those cases a public good is provided because the court decision will have a *de facto* effect on behalf of all the shareholders. As the benefit of the suit is not privatized, that is, only partial internalization for the plaintiff takes place, reducing the expected costs gives an incentive to the individual to overcome - at least partially - the free-rider problem.

[119] § 91 ZPO. Law firms in Germany thus have a higher incentive to take a case they do not deem successful as they get paid anyway. Nevertheless, other factors may also play a role, such as reputation and psychological factors.
[120] § 247 (1) AktG.
[121] § 247 (1) and (2) AktG.
[122] § 146 AktG.
[123] § 122 (4) AktG.
[124] GKG, Annex 1.
[125] § 132 (5) AktG.
[126] § 98 and 99 (VI) AktG.

The legal rules are just the opposite concerning the German equivalent to a derivative suit: the initiation of an action against the management under § 147 AktG. Even if the minority was successful in petitioning the court and a special representative was appointed, the minority has to reimburse the corporation for the costs of the trial in the event that the action by the special representative on behalf of the corporation fails. This includes the costs of the special representative.[127]A likely scenario is as follows: Management fails to bring an action against itself, but the required minority succeeds with a petition in court to appoint a special representative to bring the claim on behalf of the corporation. If the action is brought by the special representative and fails, the minority has to bear all litigation costs. Thus, even if the hurdle of gathering a quorum is overcome, and the court does appoint a representative, there is still the possibility that the minority has to bear all the costs, whereas, in the case of success, it would only partly reap the benefits. The incentive to initiate an action according to § 147 AktG is thus minimized. The principal purpose of a fee-shifting regime is to make winning parties whole, that is, to create full internalization concerning litigation costs.[128] If the shareholder could predict the trial outcome without error, as shall be assumed here for simplicity's sake, then the plaintiff would not bring a frivolous suit and would never be discouraged by litigation expenses from bringing a meritorious suit, which would guarantee the plaintiff reimbursement of its litigation expenses. This holds true for individual suits where the plaintiff claims violation of a personal right. If the shareholder provides a public good or a partial public good by controlling the legality of behavior of management, she is only partially "made whole" with regard to the decision itself, since the incentive to launch a meritorious suit is lessened in that case. In essence: even if the German system creates incentives concerning the costs for individual suits, incentives for suing on behalf of the corporation against managers are *inter alia* minimal.

Under the "American rule", a prevailing party is not ordinarily entitled to collect a reasonable attorneys' fee[129] from the losing party. Thus, each federal court litigant must normally bear its own fees.[130] Thus, as fees are not shifted, each side is left responsible for its own lawyers'

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[127] § 147 (4) AktG.

[128] In economic terms this would mean to bring the individual back to the indifference curve (utility level), where it used to be before the disputed behavior took place.

[129] For an overview of the literature concerning attorney's fees, see *Kritzer*, Lawyer Fees and Lawyer Behavior in Litigation: What Does the Empirical Literature Really Say?, 80 Tex. L. Rev. (2002), 1943ff.

[130] This general rule, which applies in all states with the exception of the state of Alaska, of non-recovery of counsel fees, however, is subject to certain exceptions. Parties may avoid the application of the general rule by contracting for the losing party to pay the other's attorney's fees. Two further exceptions to the American rule are the common benefit exception, whereby a court may grant fees to a party whose suit resulted in a benefit to the public, and the litigant's misconduct exception, whereby a court may impose fees on a party who has engaged in misconduct of the litigation. Furthermore, the American rule is overridden when there is an express statutory provision permitting the award of attorney's fees to the prevailing party.

fees, regardless of which party ultimately wins.[131] This rule does not induce optimal litigation decisions.[132] Plaintiffs will not bring all meritorious suits. Even if the plaintiff can count on the court to decide the case as the plaintiff predicts, the plaintiff will not sue if its litigation costs exceed the value of the relief that it expects the court to award. For individual suits, where full internalization takes place as a personal right is concerned, this leads to suboptimal levels of suits, if control of management is also considered. The problem of foregone actions because expected costs exceed expected utility is mitigated in a class action as the attorney's fees are distributed among the whole class.[133] The class member is not liable for any costs or fees except those deducted from the proceeds of a successful litigation, and the personal claim of a class member will not be time-barred because the statute of limitations is tolled by the class action. On the other hand, the individual class member's substantive rights are bound with those of the class and are subject to extinction by an adverse result.

With regard to derivative suits, the problem of the American rule would be aggravated, as a successful action provides a public good. As such, for the plaintiff, only partial internalization takes place and only in an indirect way, as the action is brought on behalf of the corporation. All shareholders and stakeholders profit from a successful action, whereas the costs are privatized. For this reason, the general American rule is altered in the case of derivative suits. To match costs and utility of a suit, courts decide based on considerations of equity in the event of a successful derivative action that either the corporation or the defendants of the "second suit", for example, the management has to bear the costs.[134] Where the court believes the action is extortionate, it may shift all costs, including the fees of the defendant, to the shareholder-plaintiff.[135] This rule is flexible enough to either rise the expected costs for a plaintiff very high and probably too high for a derivative suit on the one hand or to lower the expected costs for a meritorious suit on the other as even if the suit fails, the court may shift

[131] The consequence of this rule is nevertheless mitigated due to frequent contingent fee agreements. Under such an agreement, the plaintiff may receive the attorney´s services entirely for "free" in the sense that he does not have to pay if he loses the case.

[132] See for an economic analysis of the fee rules e.g. *Polinsky/Rubinfeld*, Does the English Rule Discourage Low-Probability-of-Prevailing Plaintiffs?, J. Legal Stud. 27 (1998), 519ff.; *Polinsky/Rubinfeld*, Sanctioning Frivolous Suits: An Economic Analysis, Geo. L.J. 82 (1993), 397ff.; *Rosenberg/Shavell*, A Model in Which Suits are Brought for Their Nuisance Value, Int'l Rev. L. & Econ. 5 (1985), 3ff.; *Bebchuk/Chang*, An Analysis of Fee Shifting Based on the Margin of Victory: On Frivolous Suits, Meritorious Suits, and the Role of Rule 11, J. Legal Stud. 25 (1996), 371ff.; *Bebchuk*, Suing Solely to Extract a Settlement Offer, J. Legal Stud. 17 (1988), 437ff.; *Avery Katz*, The Effect of Frivolous Lawsuits on the Settlement of Litigation, Int'l Rev. L. & Econ. 10 (1990), 3ff.

[133] *Coffee, Jr.*, Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions, Colum. L. Rev. 86 (1986) 669.

[134] Tanzer v. Huffines, 315 F.Supp. 1140 (D.Del. 1970); Mc Donell Douglas Corp. v. Palley, 310 A2d 635 (Del. 1973).

[135] F.D.Rich Co. Inc., v. U.S. Industril Lumber Co.,Inc. 417 U.S. 116 (129), 94 S.Ct. 2157 (1974); Roadway Express v. Piper, 447 U.S. 752, 100 S.Ct. 2455 (1980).

the costs to the corporation if the suit is seen to be in the interest of the corporation.[136] Nevertheless, if the court does not shift fees, the plaintiff-shareholder is left to pay the fees of her attorney.[137]

### *VI. Evaluation of the German and the American System from an Economic Viewpoint*

While shareholders do have direct democratic rights concerning the legislative matters such as important decisions concerning the corporation, control of the executive is not well developed in Germany. It is even debatable if legislative control matters most, as the ever broadened discretion of management is no longer a disputed phenomenon. Decisions of management, applying the law or the statutes of incorporation with corresponding discretion may be much more important for the utility of shareholder (or the shareholder value) than decisions by the shareholders' meeting. Nevertheless, apart from the necessity of business judgment, "as a practical matter, the logic of collective action leaves the dispersed shareholders of large companies with little alternative to delegating management powers."[138] German procedural law privileges the enforcement of individual rights. Yet, management decisions generally affect all shareholders. Infringements of shareholders' rights and interests happen on a daily basis, but in a lot of cases the harm done is negligible or intangible so that the legal system either denies the right of action or the action does not seem individually profitable. However, these mass damages pose a problem that the law should address. A solution of the control problem is necessarily weakened, if there is no corresponding means of enforcement of the law, that is, it is insufficient to only state certain obligations of the management in substantive law without effectively enforcing it by forming the procedural law correspondingly.[139] In instances where the law grants standing to a single shareholder and the claim is about the legality of a legislative decision or about the appointment of a special auditor as in Germany, an action brought by the shareholder provides a public good. The incentive to sue is therefore small, if the costs have to be borne without exception by the shareholder where the suit is unsuccessful. This problem is solved on the cost side of the action for example by the American provision for derivative suits, allowing the judges to shift fees according to the beneficiary of the action (the corporation) or the misfeasor. As suggested above, the fee-

[136] The action may be in the corporation's interest, if it succeeds in disciplining or removing management, see *Becker*, Verwaltungskontrolle, 161.
[137] See *Kraakman/Park/Shavell*, When Are Shareholder Suits in Shareholder Interests?, 1741f. for the incentives for bringing a derivative suit under a benchmark regime allocating costs pro rata (shareholder bears costs only to an amount equal to his ownership interest) and under a contingency fee regime.
[138] *Kraakman/Hansmann,* Chapter 3: The Basic Governance Structure, 17.
[139] In that sense already the Reichsoberhandelsgericht, ROHG, 25, 307, 310. See for a discussion of the notion of subjective rights in the context of shareholders rights *Schulz-Gardyan*, Die sogenannte Aktionärsklage, 57-67.

shifting rule should be handled in view of the utility of the claim to align costs and benefits of those suits.[140] Another possibility for Germany is the introduction of class actions for shareholders, which, through reducing the costs, align costs and benefits as far as the shareholders are concerned (even if other stakeholders, such as creditors, are still free-riding).[141] If a manager's breach of duty injures shareholders directly, as, for example, where directors are alleged to have wrongfully approved the sale of the company at an unfair price, a shareholder can sue directly as the named plaintiff on behalf of the shareholder class, and any recoveries will go to the plaintiff class directly rather than to the corporation.

Furthermore, German law discriminates against those interests which are written only in objective law. There is neither an enforceable subjective right to an individual or a representative suit on behalf of the corporation. Fraudulent behavior of the management can thus not be controlled by individual shareholders. Nevertheless, American and German law allow for a suit on behalf of the corporation. Both systems impose substantial initial hurdles on those shareholders who wish to have an action brought on behalf of the corporation. The requirement of a quorum in Germany to initiate a suit raises the initial costs involved in gathering the minority, whereas in the US this barrier is erected through the requirement of demand. In Germany, the minority loses control of the suit since a special representative needs to be appointed, an the minority is possibly nevertheless burdened with the costs. The more flexible American fee system allows for an adequate alignment of costs and benefits of the suit, whereas the German system does not use this instrument. Shareholder protection, that is, internalization and control of management in the US through judicial review, is made easier than in Germany, if the incentive structure of the individual shareholder is taken into account.

### *VII. Suggestions for Avoiding Abuse of Action*

In general, it can be inferred from the analysis that the incentive for the individual to sue is not very high. Nevertheless, the phenomenon of extortionate suits exists. Those suits can be

[140] As here *Becker*, Verwaltungskontrolle, 475.

[141] The resolution E. g) 1.15. of the 64. Deutscher Juristentag in Berlin 2002 recommended the implementation of class action for investors. See also the expert opinion of *Fleischer* on the reform of capital market law for that same congress: *Fleischer*, Empfiehlt es sich, im Interesse des Anlegerschutzes und zur Förderung des Finanzplatzes Deutschland das Kapitalmarktrecht und Börsenrecht neu zu regeln?, Verhandlungen des vierundsechzigsten Deutschen Juristentages, Vol. 1. See also United Nations G-24 Discussion papers Series Research Papers for the Intergovernmental Group of Twenty-Four on International Monetary Affairs (2002), 15 on corporate law, where the creation of shareholders rights (especially concerning disclosure by management) that are easily enforceable is called for. *Heß*, Sammelklagen, 116 argues against the introduction of class actions as they may shorten rights of members of the class. Also *Baums* (Ed.), Corporate Governance, 202 argues against class action and suggests to rely on the procedural means already in place.

named Negative-expected-value (NEV) suits, in which the expected litigation costs exceed the expected utility of a favorable judgment.[142] They can be explained by settlement offers. If the *ex ante* probability of winning the case is taken into account, one can generally state that under the fee-shifting rule, the lower a plaintiff's probability of prevailing, the more likely it is that he will bear not only his own costs at trial but also the defendant's legal costs. Under the American rule, in contrast, the plaintiff in general does not have to pay the defendant's legal costs. Consequently, there will be some low probability plaintiffs who will be deterred from bringing suits under the English rule since they have to bear higher costs in case they lose, but who will sue and go to trial under the American rule.[143] A plaintiff will pursue an NEV suit only if he expects to extract a positive settlement offer from the defendant. A rational defendant will of course not settle if he expects to win the case, but there might be several reasons for settling nonetheless. One is uncompensated time and costs. The time factor may be very important for corporations, as in certain cases, for example, in the event that a decision needs to be recorded in the commercial register, it is prevented from acting.[144] This may result in (costly) foregone business opportunities. Another reason for settlement is the bad reputation and media coverage following a pending action. Furthermore, the credibility of the plaintiff to go to court or not to settle in a pending action may play a role.[145]

There are several ways extortionate suits may be restricted without restricting the general incentives and legal possibilities of shareholders to control management through legal action. There is no need to restrict the individual standing provision on a general basis.[146] One way of separating extortionate suits from meritorious suits may be seen in the German approach to individual actions of rescission of a shareholders' meeting decision. It was decided that in individual cases there can be an abuse of right that leads to the dismissal of the case.[147] The BGH[148] was unequivocal in stating that this decision states that upcoming cases have to be judged on an individual case-by-case basis and is thus not to be understood as an institutional precedent. This decision is similar concerning the deterrence effect with regard to extortionate suits to the equity rule in derivative suits in the US, where the fee shifting of the costs depends upon the merits of the case. There, the court is given the possibility to judge the fee-

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[142] See for this notion *Bebchuk*, A New Theory Concerning the Credibility and Success of Threats to Sue, J. Legal Stud. 25 (1996), 1ff.

[143] See *Polinsky/Rubinfeld*, Does the English Rule Discourage Low-Probability-of-Prevailing Plaintiffs?, in: J. Legal Stud. 27 (1998), 519ff. For an economic analysis of settlements, see *Bebchuk*, A New Theory, 1.

[144] Filing a suit causes a blockade in the register, e.g. § 16 (2) UmwG and § 319 (V) AktG and in some other cases. This problem might be solved otherwise, namely by giving the corporation the possibility to stop the barricade of register. See also the resolution I. 14. A. BB. a) of the 63. Deutscher Juristentag.

[145] This is the reason *Bebchuk*, A New Theory, is focusing on.

[146] But see *Baums*, Gutachten zum 63. Deutschen Juristentag, S. F 102.

[147] BGHZ 107, 296 –"Kochs Adler".

shifting depending upon the motives of the plaintiff on one hand, and on the utility for the corporation on the other. The German provision is nevertheless an *ex ante* control by the courts, whereas the US cost shifting rule is an *ex post* device. Therefore, it is also possible to introduce a fee-shifting possibility based on considerations of equity – in deviation from § 91 ZPO - in Germany. Thereby, costs and benefits of the suit are brought into line. Small shareholders would then not be discouraged from launching meritorious suits.[149] It is not helpful to have a rule as § 147 (4) AktG, where the minority initiating an action has to bear all the costs if the corporation loses the case. The costs should be shifted according to the benefit of such a suit. If a suit concerns a public good, the courts should have discretion to shift fees, even if the suit fails.

Another possibility is the requirement of publication of settlements in and out of court. This kind of publication would prevent management from colluding and make public the names of those shareholders who make a living out of strike suits. Further, the legal validity of the settlement can be made dependant on control by the court, similarly to the US rules concerning class actions. Another possibility is the pre-trial decision of the case by the courts, where the merit of the case is summarily judged. Only in case of sufficient prediction of success can the action go ahead.[150]

## *VIII. Conclusion*

Shareholder suits are not only – as mostly discussed in the literature - a technique of internal control of management, but also a means of internalization of those externalities caused by the management. If shareholders' passivity is an (oftentimes deplored) fact, legal mechanisms need to be analyzed with regard to possibilities of fostering shareholder activism. A careful analysis is needed to find those institutions which do not prohibit meritorious suits and prevent strike suits. This can be done only by having a close look at the individual incentive structures for bringing a suit. Such structures differ, depending mainly on the one hand on the claim and therefore the utility of the individual in case of a successful suit, and on the other, on the cost side of the suit, which may be influenced by procedural provisions and flexible fee-shifting rules. The US-American approach allows for more shareholder activism concerning management control than the German approach. At the same time it allows a more flexible approach for deterring frivolous suits by a less rigid cost regime.

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[148] BGHZ 107, 296, 310.

[149] But see *Baums* (Ed.), Bericht der Regierungskommission, 184, where it is argued that meritorious cases are always (sic!, A.v.A.) launched and therefore no additional incentive is needed.

[150] See also the resolutions II. 5. a) of the 63. Deutscher Juristentag.