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To sue or not to sue? Shareholders’ actions to set aside resolutions of the General Meeting: economic analysis and recent reforms in Europe


Broader view: Shareholder suits in context

• Market mechanisms, e.g.
  – Market for corporate control (to a degree dependent on ownership structure and available anti-takeover devices)
  – Disciplining influence of expectations with regard to the future cost of capital (dependent on market efficiency)
Broader view: Shareholder suits in context

- **Legal** instruments, e.g.
  - (qualified) majority voting
  - Limitation on control enhancing mechanisms (vary significantly from country to country)
  - Independent directors
  - Board committees
  - External auditors

Closer look: Centralised (external) vs. decentralised (internal) enforcement regimes

- **Centralised** compliance-enforcing mechanisms, e.g.:
  - State supervisory and regulatory authorities (SEC)
- **Decentralised** compliance-enforcing mechanisms, e.g.:
  - Whistleblowing (post-Enron developments – SOX)
  - Shareholder strategy:
    - Voice
    - Exit
    - Suit
Focus: Shareholders’ legal actions

Shareholders’ legal actions are not a homogenous category, as they involve dogmatic, technical, and economic differences. These differences depend on ownership structure, governance, and legal culture.

Shareholder litigation: classification

- Depending on level, where the action is situated:
  - **Legislative** level (action to set aside GM resolutions)
  - **Executive** level (actions for damages ↔ liability of corporate officers)

- Depending on violated rights and interests
  - Infringement of **personal rights** of a given shareholder – direct loss
  - Infringement of **company’s interest** (Derivative suits) – indirect loss = reflex-damage
Shareholder litigation: classification

- Depending on **procedural** matters:
  - Individual suits
  - Class action
  - Individual
  - Quorum-dependent

Shareholder suits and agency problem

<table>
<thead>
<tr>
<th>Lines of corporate agency conflicts</th>
<th>Corresponding shareholder actions</th>
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<tr>
<td>shareholders vs. managers</td>
<td>derivative suit, direct suit</td>
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<tr>
<td>• typical of dispersed ownership</td>
<td>• Liability rule</td>
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<tr>
<td>controlling shareholder vs. minority shareholders</td>
<td>action to set aside resolution of GM</td>
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<td>• typical of concentrated ownership</td>
<td>(action of rescission)</td>
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<td>[shareholders vs. other stakeholders]</td>
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Shareholder suits under various models of corporate law

- **Mandatory** corporate law
- **Enabling** corporate legislation with broad autonomy left with shareholders to design articles of association to fit their particular needs

In any of the above identified models their functionality relies equally importantly on efficient enforcing mechanisms – i.a. on private shareholder litigation

Shareholder suits and corporate governance

- Basic assumptions regarding corporate structure and powers:
  - The principle of *majority rule*
  - The principle of acting through company’s *organs* (←*legal personality*)
Shareholder suits and majority rule

- Correction of the **majority rule**, insofar as:
  - the protection by means of voting rights inherent to share ownership is insufficient as a result of given ownership structure and voting thresholds
  &
  - Controlling shareholder or majority of shareholders pursues an action that is contrary to the law, good faith or corporate constitution (articles of association)
    & (in some jurisdictions, although under the majority of European legal orders shareholder’s litigation is classified as *actio popularis*)
  - Controlling shareholder’s action infringes upon minority shareholder’s interest

Shareholder suits and corporate powers

- Correction of the principle that the company **acts through its legal representatives** (management), insofar as:
  - The management remains passive and neglects its duty to act in the interest of the company, usually by refraining from suing for compensation of damages suffered by a company (usually this passivity results from conflict of interest)
Stronger role of GM in Continental Europe

- **concentrated ownership** – most corporations do have a controlling or other significant shareholder capable of extracting private benefits of control
- traditional view on **shareholder democracy** – shareholders as “owners” of the company shall have decision-making powers with respect to the important transactions and operations of the company

- **long list of powers** assigned to the GM by mandatory law. E.g. in Germany additional “implied powers” of the GM are granted by the courts (Holzmüller, Gelatine-Judgements of the Federal Supreme Court)
- increased significance of shareholders’ right to challenge the resolution of the GM (legislative level)
- poor enforcement of managerial duties by shareholders by means of derivative actions
Correcting role of action of rescission

- Shareholder suits aim at **verifying** decisions made by the GM, so that the court may order to:
  - revoke / void / annul
  - modify (e.g. in France, Finland)

In search for an efficient legal framework

- **Mechanisms** preventing/discouraging abusive suits (**strike suits**)
- **Framework** promoting filling legitimate suits

Equilibrium: where marginal utility of any additional suit equals the marginal cost of that suit → maximizing social welfare

- if abusive action is allowed = Type I error (false positive)
- if legitimate suits not brought = Type II error (false negative)
In search for an efficient legal framework

Promoting legitimate suits
- Collective actions = bundling dispersed interests
- Costs & lawyer fees
- Procedure and evidence

Preventing abusive suits
- Reduction of blackmail potential of a suit
- Finetuning of the stoppage effect of the action
- Focusing on proper interest: investment protection vs. shareholders' co-determination of corporate affairs

Proper focus: shifting from controlling of legislative level (property) to the executive level (liability)?

Economic rationale

- Problem of curbing opportunistic behaviour of a controlling individual
  - Corporate controller might be tempted to engage in rent seeking instead of profit maximising \(\rightarrow\) externalities
  - Suits as a means of \textit{internalisation} of these externalities and thus discouraging opportunistic behaviour
Litigation game

- ELV = Shareholder’s expected litigation value
- \( V' \) = Value of the company prior to the dubious resolution = 12.000
- \( V'' \) = Value of the company after the resolution = 10.000
- \( V_r \) = Value of the relief = 2.000 = – (Value of the resolution)

Litigation game

- H (Hamlet): shareholder holding 1 share (out of 100)
- C (Claudius): shareholder holding 10 shares (out of 100)
- \( N_s \) = number of suing shareholders
- \( P \) = Probability of relief (probability of success of shareholder action) = 50%
- \( (1-P) \) = Probability of action’s dismissal = 50%
### Litigation game

- **E** = cost of litigation (fees) / refundable upon success, splitable depending on the number of suing shareholders / = 20
- **e** = variable opportunity costs (time spent, efforts, monitoring) / non-refundable, splitable depending on the number of suing shareholders / = 6
- **ef** = fix opportunity costs / non-refundable, non-splitable / = 6
- Litigation costs and undergone opportunities on the part of the company: neglected

### First scenario: H(+), C(+)
(Shareholder's expected litigation value)

- **ELV(H)** = \( \frac{(V'' + Vr \times P)}{H/100} - \frac{E \times (1-P)}{Ns} - \frac{e}{Ns} - ef \)
- **ELV(C)** = \( \frac{(V'' + Vr \times P)}{C/100} - \frac{E \times (1-P)}{Ns} - \frac{e}{Ns} - ef \)

- **ELV(H)** = 10.000 + 2.000 x 50% / 100 – 20 x 50% / 2 – 6 / 2 – 6 = 110 – 5 – 3 – 6 = 96
- **ELV(C)** = 10.000 + 2.000 x 50% / 10 – 20 x 50% / 2 – 6 / 2 – 6 = 1100 – 5 – 3 – 6 = 1.086
H(+) , C(+) payoffs

<table>
<thead>
<tr>
<th>Claudius</th>
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<tr>
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<td>Sues (+)</td>
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<tr>
<td>Hamlet</td>
<td>ELV(H)= 96</td>
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<td>ELV(C)= 1.086</td>
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Second scenario: H(+) , C(-)  
(Shareholder’s expected litigation value)

- ELV(H)= (V’’ + Vr x P)/ H/100 – E x (1-P)/Ns – e/Ns – ef
- ELV(C)= (V’’ + Vr x P)/ C/100

ELV(H)=10.000+2.000x50% / 100 – 20x50% / 1 – 6/1 – 6 = 110 – 10 – 6 – 6 = 88
ELV(C) = 10.000+2.000x50% / 10 = 1.100
H(+), C(-) payoffs

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<td>Sues (+)</td>
<td>Doesn’t sue (-)</td>
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<tr>
<td>ELV(H)= 88 [\text{Negative ELV } &lt; 100 \text{ if no suit}]</td>
<td>ELV(C)= 1.100 [\text{Positive ELV } &gt; 1.000 \text{ if no suit}]</td>
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Third scenario: H(-), C(+)
(Shareholder’s expected litigation value)

- \[\text{ELV}(H)= (V'' + Vr \times P) / H/100\]
- \[\text{ELV}(C)= (V'' + Vr \times P) / C/100 - E \times (1-P)/Ns - e/Ns - ef\]

- \[\text{ELV}(H)= 10.000 + 2.000 \times 50\% / 100 = 110\]
- \[\text{ELV}(C)= 10.000 + 2.000 \times 50\% / 10 - 20 \times 50\% / 1 - 6/1 - 6 = 1.100 - 10 - 6 - 6 = 1.078\]
### H(-), C(+) payoffs

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<td>Positive ELV &gt; 1.078 if no suit</td>
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### Fourth scenario: H(-), C(-)
*(Shareholder’s expected litigation value)*

- ELV(H) = $V'' / H/100$
- ELV(C) = $V'' / C/100$

- ELV(H) = 10.000 / 100 = 100
- ELV(C) = 10.000 / 10 = 1.000
### H(-), C(-) payoffs

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</table>
|       | Sues (+)      | Doesn’t sue (-)
| Sues (+) |               |       |
|       |                |       |
| Doesn’t sue | ELV(H) = 100  | Neutral ELV = 100 if no suit |
|       | ELV(C) = 1.000| Neutral ELV = 1.000 in no suit |

### Payoffs: overall picture

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|       | Sues (+)      | Doesn’t sue (-)
| Sues (+) |               |       |
|       | ELV(H) = 96   | ELV(C) = 1.086 |
|       | Negative ELV < 100 if no suit | Positive ELV > 1.000 if no suit |
| Doesn’t sue | ELV(H) = 88   | ELV(C) = 1.100 |
|       | Negative ELV < 100 if no suit | Positive ELV > 1.000 if no suit |
|       | ELV(H) = 110  | ELV(C) = 1.086 |
|       | Positive ELV > 100 if no suit | Positive ELV > 1.078 if no suit |
|       | ELV(H) = 100  | ELV(C) = 1.000 |
|       | Neutral ELV = 100 if no suit | Neutral ELV = 1.000 in no suit |
Law and Economics assessment

• If the corporation prevails, the suing shareholder – even acting bona fide – has to bear the costs:
  – his own, and
  – those of the winning party
    • YES under the European rule;
    • NO under the American rule, where each party bears its own costs

Law and Economics assessment

• If the shareholder’s action is successful, the suing shareholder might
  – benefit pro rata from his action aiming at combating misbehaviour of managers or controlling shareholder → action aims at restoration of status quo ante (*restitutio in integrum*) or compensation
  – get refunded for his expenses
    • YES under the European rule;
    • (exceptionally) YES under the American rule according the so-called substantial benefit doctrine
  – remain with a part of his expenditures and efforts uncompensated

No punitive damages → payoff ≤ zero
If the corporation is sued (which dogmatically follows from the legal personality doctrine) – as it is the case in actions of rescission – the management board has all corporate resources at its disposal.

In economic terms the opposing shareholders financially contribute on a *pro rata*-basis to fighting themselves in a lawsuit and they also *pro rata* bear the costs of litigation and enforcement(!)

Private enforcement of public interest – proper management and “corporate legislation” as a public good (non-exclusive, non-rival) → private production of **public good**

**Collective action** problem

Asymmetric payoffs → positive externalities of shareholder action (**free riding** problem)
Externalities

• Public goods:
  – Intra-corporate:
    • Protection of interest of the shareholders as a group
  – Extra-corporate
    • legal development, production of case law, clarification of legal issues, general deterrence, safe harbours

• Costs:
  – Enforcement, consumption of public infrastructure (courts)

Why to sue if ELV negative?

• Idealistic motives
• Strategic motives: Repeated game setting (oppression in stages → anticipation of future misbehaviours → preventive function pro futuro)
• Opportunistic motives
  – corporate blackmail
  – settlements: transfers from the corporation to the opposing shareholder
Recent reforms in Europe

Germany (2005)

Italy (2003)

German Reform – UMAG (2005)

- Reform of the organisation of the GM
- Shareholders’ Forum – platform facilitating shareholder communication and collective actions

- Only material information deficits might now justify shareholder actions
- If the information deficits pertain to the appraisal-relevant issues, only special appraisal procedure (Spruchverfahren) shall be available to a suing shareholder
German Reform – UMAG (2005)

• Shares must have been acquired before the agenda of the GM was publicised

• All nuisance settlements and payments to the opposing shareholders must be publicised in the official Federal Bulletin

• Reduction of the blockade effect of the action based on preliminary court assessment (Freigabeverfahren)

• Bundeling rescission actions in specialised courts

German Reform – UMAG (2005)

• Promotion of the stability of corporate transactions (Bestandschutz) – if the preliminary court assessment turned out into positive for the company, and consequently the operation got registered with the registration court, subsequent prevailing of the opposing shareholder in the main procedure (trial) shall not reverse the operation – shareholder is left with monetary damages only
Germany: UMAG (2005) and beyond

- **Rejected proposals:**
  - Quorum of 2-5%
  - Minimum shareholding period of 3 months prior to filling a suit

- Post-reform empirical studies reveal no improvement in fighting rent seeking litigation (strike suits)

- Further technical reform: ARUG (2008)

- Possible far-reaching reform – Quorum requirement (DJT 2008)

Italian Reform 2003

- **Right of action:**
  - **Quorum:**
    - 0.1% for listed corporations
    - 5% for non-listed corporations

- Shareholders who fall below these thresholds might only sue for damages – not for rescission or annulment of the GM-resolution

- Independent of the actual presence at the GM (acknowledged already before)
Italian Reform 2003

Shareholders shall be allowed to bring action against decisions of the management board, provided the resolution of the management board violates individual/personal rights of a suing shareholder (no actio popularis, unlike the regular action for rescission).

Right of the Consob (SEC) – under exceptional circumstances - to demand annulment of resolutions approving financial statements of a listed company.

Improved injunction relief ➔ suspension of the execution of the resolution in question.

Some empirical evidence from Poland

Number of successful actions (in full or in part) 2002-2007

- Uwzględniono w całości lub części
- Ogół załatwionych spraw
Future reforms in Poland?

- What do experts and stakeholders think, should be done to further improve the regulatory framework? – survey organised at the joint Corporate Governance Conference of Centrum C-Law.org and the Warsaw Stock Exchange, Oct. 19th, 2006.
Is it appropriate to ease the protection of membership of small investors and to substitute it by protection of the monetary value of the investors' interest?

- 56% yes
- 25% no
- 19% hard to say

Respondents (52 Questionnaires)

- 50.5% legal scholarship
- 17.3%宏观经济
- 11.5% entrepreneurs of public limited company
- 7.6% small company
- 5.8% institutional investors
- 5.8% public administration and governmental
- 3.8% financial intermediary
- 1.9% others
- 1.0% trade unions
- 1.0% practicing lawyers
- 1.0% All answers:
If the focus should be on the monetary interest of shareholders, is it appropriate to install a special procedure aiming solely at determining the amount of indemnification? 

32 answers: 
- yes 
- no 
- hard to say

Should the right of shareholder to sue against the resolution be dependent on a minimum share capital held by that shareholder (e.g., 1%)?

Na pytanie nr 35 udzieliło odpowiedzi 46 osób, z czego:
- tak, 1% to właściwy próg
- tak, ale od wyższego prógu, np. 5%
- tak, ale od niższego prógu, np. 0.1%
- nie
- nie mam zdania
Should also to shareholders absent of the GM be granted the right to suit against resolutions made at that meeting?

- 46 answers
  - yes, in all matters
  - yes, but only as far as the resolution concerns pecuniary interest of the shareholder and the suit is not aimed at voiding the resolution but instead at obtaining indemnification.
  - no
  - hard to say

Should shareholders be entitled to challenge the resolutions of management board as well?

- 43 answers:
  - yes, to the same extent as they can challenge resolutions of shareholder GM
  - yes, but only matters delegated on the management from the GM (e.g. authorised capital increase)
  - yes, but only in exceptional cases, subject to explicit legal provision.
  - no
  - hard to say
Conclusions

- European corporate laws grant more right to the GM than American laws do

- In Continental Europe, particularly in German legal family the main shareholder action is the action to set aside resolutions of GM (action for rescission)

- Action for rescission aims at the legislative level

Conclusions

- For reasons of information asymmetry and transaction costs shareholders are not in the position to make fully informed decisions with regard to the company’s affairs

- Actions at legislative level are less accurate and less capable of protecting shareholders’ interest as compared with actions aiming at executive level

- Actions at executive level are less popular in Europe due to concentrated ownership structure, frequent forum requirements, existing legal tradition and asymmetric payoffs
Conclusions

- A substantial number of suits with negative ELV are brought as a means of profit seeking (blackmail)

- This phenomena requires counter-measures, i.a. in form of reducing right to action for rescission (quorum) by shareholders with tiny stakes and substituting it by compensatory damages (direct or derivative suits against wrongdoers), including balanced litigation cost regime

Suggested quotation:
A. Radwan, To sue or not to sue? Shareholders’ actions to set aside resolutions of the General Meeting: economic analysis and recent reforms in Europe, Presentation at the Nordic Company Law Seminar, Oslo Sept.3rd, 2008, <URL>, slide [n]