Empirical Studies of Derivative Actions in Japan

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I, Yusaku Kurahashi, confirm that the work presented in this thesis is my own. Where information has been derived from other sources, I confirm that this has been indicated in the thesis.

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ABSTRACT

The overall purpose of the research is to give a clear picture of how derivative actions work in Japan, where shareholders, in principle, are able to file the actions much more easily than other jurisdictions including the United States and the United Kingdom.

Chapter I examines theoretical functions and problems associated with derivative actions in the context of corporate governance issues. It demonstrates that while working as a remedy to mitigate the agency problems between the directors and the company, derivative actions would create another agency problem between the self-selected plaintiff shareholder and the company. Chapter II examines how derivative actions practically function in the United States and the United Kingdom so as to provide benchmarks against Japan's counterpart. Chapter III describes how the policy and practice regarding derivative actions have developed in Japan since its introduction in 1950. Chapter IV provides methodology and outlines of an empirical description of derivative actions in Japan. Chapter V and VI thoroughly investigates all derivative actions on behalf of listed companies and closed companies respectively, whose proceedings ended at the Tokyo District Court during the period between 2011 to 2016. The Tokyo District Court provided the author with a list of such cases, which allows the comprehensive examination of how derivative actions work in practice.

The thesis concludes with some implications for policy design.

Impact Statement

The primary aim of this research is to empirically examine whether derivative actions function as an effective corporate governance tool in Japan. The derivative action is the avenue by which minority shareholders are able to enforce the company's rights against directors where they have breached their duties. The rationale for letting a self-selected plaintiff shareholder initiate a derivative action on behalf of the company is that the directors are not expected to optimally bring a claim against its (ex-) colleague.

Much attention has been given to the issue of how to design the system of the derivative action with respect to the debate about corporate governance. The threat of the derivative action is thought to encourage directors to act in the interests of the shareholders as a whole, thus addressing the agency problem between dispersed shareholders and management. However, there is a risk of its side effects. In particular, given that the plaintiff shareholder is self-selected, the derivative action might create the litigation agency problem between a plaintiff shareholder and shareholders as a whole. We must thus determine whether the current derivative action is effectively used to mitigate the agency problem and whether the company suffers from the overuse and abuse of derivative actions.

These questions remain unanswered in Japan because of a lack of empirical research on the topic. The main purpose of this study is to provide new evidence, based on hand-collected data sets, on the frequency and dispositions of the

derivative action in Japan. The research looked into conducting a study of the derivative actions filed in the Tokyo District Court which account for approximately one-third of all actions nationwide. With the special cooperation of the Tokyo District Court, I was able to obtain a list of all derivative actions (a total of over 113 cases) concluded there from 2011 through 2016. In addition, I was also given a special opportunity to view the court records for such cases. By examining the records for these cases, I will be able to comprehensively study all the derivative actions that were actually ended in a set period in the Tokyo District Court.

This research will provide evidence of the comparative references in the discussion of reforming the system of the derivative action. In particular, the Japanese derivative action has unique features that the Companies Act provides shareholders with a much more easily accessible derivative action avenue without sufficient safeguards compared to other jurisdictions such as the United States and the United Kingdom. These features have led to a large number of derivative actions in Japan and make it possible to research the realities thereof and are a source of new data and evidence for the debate about the effectiveness of the derivative action.

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INTRODUCTION

The primary aim of this research is to empirically examine whether derivative actions function as an effective corporate governance tool in Japan, where shareholders, in principle, are able to file the actions much more easily than other jurisdictions including the United States and the United Kingdom. The derivative action is the avenue by which minority shareholders are able to enforce the company's rights against directors where they have breached their duties. The rationale for letting a self-selected plaintiff shareholder initiate a derivative action on behalf of the company is that the directors are not expected to optimally bring a claim against its (ex-) colleague (see below in Chapter I).

Much attention has been given to the issue of how to design the system of the derivative action with respect to the debate about corporate governance. The threat of the derivative action would potentially encourage the directors to act in the interests of the shareholders as a whole, and therefore addressing the agency problem between dispersed shareholders and the management. However, there is a risk of its side effects. In particular, given that the plaintiff shareholder is self-selected, the derivative action might be detrimental to the interests of the company because (1) the plaintiff cannot be expected to have appropriate expertise and information in every case, (2) the plaintiff does not necessarily have an incentive to consider the best interests of the company, or (3) the plaintiff might

bring a claim opportunistically. We, therefore, need to set a right balance between "accessibility" of the derivative action for shareholders and "safeguards" against abuse and inappropriate use. The questions are whether the current derivative action is effectively used to mitigate the agency problem and whether the company suffers from the overuse and abuse of the derivative action (see below in Chapter I).

These questions remain unanswered in Japan because of a lack of empirical research on the topic. The main purpose of this study is to provide new evidence, based on hand-collected data sets, on the frequency and dispositions of the derivative action in Japan. The research will also investigate characteristics of plaintiffs, subject companies, and sued directors as well as categories of the director's liability claimed in the actions. These observations offer new clues as to what function the derivative action actually serves in Japan.

The official statistics of the Supreme Court reports the number of derivative actions newly brought each year and pending at each end of the year at district courts as follows. The Tokyo District Court also reports the number of derivative actions newly brought each year as follows (for these sources see below n 356).

Table 1: Number of Newly Filed Derivative Action Cases in All District Courts in Japan and the Tokyo District Court

Year	*All*	*Tokyo*	*Year*	*All*	*Tokyo*
1950 - 1989	10				
1990	4		2004	78	29
1991	5		2005	70	24
1992	12	5	2006	72	25
1993	-	18	2007	70	29
1994	-	35	2008	64	17
1995	-	22	2009	70	20
1996	68	16	2010	78	27
1997	88	36	2011	83	18
1998	73	22	2012	106	37
1999	95	30	2013	98	26
2000	84	17	2014	58	16
2001	66	17	2015	59	12
2002	78	20	2016	36	11
2003	85	20	2017	37	-
			Total	1648	549
			Mean	75.2	22.3

Note: The mean of number of newly filed derivative action cases in all district court and the Tokyo district cours shows the average case numbers for the period between 1996 and 2016.

The prior empirical studies regarding the derivative action in Japan depended on data provided by an irregular feature article, whose title was "Shuyona Kabunushi-Daihyo-Sosho Ichiran-hyo [A List of Main Derivative Actions]", in the legal journal "Shiryo-ban Shoji Homu [Commercial Law - a Data Edition]" and supplemented it by other commercial databases (see below in Chapter IV). These prior studies merely examined the outcomes of the derivative actions stated in the list above and did not conduct a full analysis regarding the causes of the defendant directors' liability as alleged by the plaintiffs. This study

will conduct a more detailed examination of the derivative actions stated in the list above in terms of (i) the attribution to the plaintiff, (ii) the attribution to the defendant, (iii) the attribution to the company, (iv) the causes of the defendant director's liability as alleged by the plaintiff, and (v) the outcomes of the action (see below in Chapter V and VI).

Furthermore, since providers of journals and databases tend to report sensational or unique cases and to ignore trivial cases, the collected data of the prior research might be under a selection bias. The research will thus be based on hand-collected data sets to avoid the selection bias. In reality as well, when confirmed with the editors of the above irregular feature article, I was told that the foregoing List of Main Derivative Actions was independently created by the editing department taking into reference journals publishing judicial precedent, other published court cases, newspaper reports and other sources, and was not an exhaustive list covering all the derivative actions that had actually been filed. As indicated above, today 1648 derivative actions have been filed until 2017 in Japan. The data relied on in prior studies accounts for only a portion of these cases, and the actions chosen were limited to those revealed in journals and newspaper reports. This thesis looked into conducting a study of the derivative actions filed in the Tokyo District Court which account for approximately one-third of all actions nationwide. I was given a special opportunity to view the court records for all derivative actions (a total of over 113 cases) concluded by the Tokyo District Court in a six year period from 2011 through 2016 (see below in Chapter IV).

By examining the records for these cases, I will be able to comprehensively study all the derivative actions that were actually filed in a set period in the Tokyo District Court (most companies have their headquarters located in Tokyo which is the economic centre of Japan, and as stated above approximately one in every three derivative actions nationwide is filed in the Tokyo District Court). This study will provide very important evidence for analysing the role that is actually being played by derivative actions.

The statutory derivative actions have been recently introduced in many jurisdictions, such as Canada, Australia, Singapore, New Zealand, and Israel, and there is an ongoing lively discussion as for what might be the optimal level of shareholders litigation with a view to enhancing its possible effectiveness, and what mechanisms might help in reaching that level (Reisberg 2007). This research will provide evidence of the comparative references in the discussion of reforming the system of the derivative action. In particular, the Japanese derivative action has unique features that the Commercial Code provides shareholders with a much more easily accessible derivative action avenue without sufficient safeguards compared with many jurisdictions, such as the United States and the United Kingdom. These features have led to a large number of derivative actions in Japan, and make it possible to research the realities thereof and are a source of new data and evidence for the debate about the effectiveness of the derivative action.

This thesis is structured as follows. Chapter I examines theoretical functions and problems associated with derivative actions in the context of

corporate governance issues. It demonstrates that while working as a remedy to mitigate the agency problems between the directors and the company, derivative actions would create another agency problem between the self-selected plaintiff shareholder and the company. Chapter II examines how derivative actions practically function in the United States and the United Kingdom so as to provide benchmarks against Japan's counterpart. Chapter III describe how the policy and practice regarding derivative actions have developed in Japan since its introduction in 1950. Chapter IV provides methodology and outlines of an empirical description of derivative actions in Japan. Chapter V and VI thoroughly investigates all derivative actions on behalf of listed companies and closed companies respectively, whose proceedings ended at the Tokyo District Court during the period between 2011 to 2016. The thesis concludes with some implications for policy design.

Chapter I: FUNCTIONS AND COSTS OF DERIVATIVE ACTIONS

1.1. Introduction

This chapter will examine theoretical functions and problems associated with derivative actions in the context of corporate governance issues. It demonstrates that while working as a compensation tool, deterrence as well as creating legal rules, and then functioning as a remedy to mitigate the agency problems between the directors and the company, derivative actions would create another agency problem between the self-selected plaintiff shareholder and the company. Therefore, we, therefore, need to set a right balance between "accessibility" of the derivative action for shareholders and "safeguards" against abuse and inappropriate use.

The chapter continues as follows. Section 1.2 describes the corporate governance context of derivative actions. Section 1.3 describes the functions of derivative actions. Section 1.4 describes the need of safeguard mechanisms of derivative actions to sort out abusive or inappropriate actions. Section 1.5 discusses the gatekeepers of derivative actions.

1.2. Approach of Research

This research has adopted a method in which a theoretical analysis has been conducted regarding the relationships of the stakeholders that enter into the picture around limited companies (shareholders, controlling shareholders, non-controlling shareholders, directors and others) and the legal systems and the like that affect their respective incentives, and validates whether this analysis can be empirically supported.

In particular, it focuses on agency theory in the consideration of the incentives for shareholders and directors. This is because there is considered to be a wealth of accumulated discourse and the competing interests among various stakeholders have been reasonably analysed. There is also analysis by contextualist theoretical model such as seen in the institutional path-dependency theory. However, when this approach is used in an effort to explain why and how a specific legal system is being utilised, there is an excessive search for "solutions" in the historical background, and it becomes difficult to critically examine the current situation. If examined through comparative law perspective, one's vision is clouded if too much emphasis is placed on historical differences. In order to analyse what is shared and what differs between divergent jurisdictions, focus must be placed not only on the historical differences but also on the question of what influence the differences of these relevant legal systems have on the incentives of the parties.

1.3. Strategies for Mitigating Agency Costs

One primary purpose of corporate law is to mitigate the agency problem between management and shareholders.[1] Directors and management are entrusted with the management of the company by shareholders. Shareholders are in the position of the "principal" and management acts as their "agent" in the discharge of its duties. Nevertheless, there is no guarantee that management will consistently act in the best interest of all shareholders. There is a constant potential for a conflict of interest between management and shareholders.[2]

Action by the "principal" shareholders is the key to mitigating of this agency problem. Shareholders have two options, to make their voice heard through voting, or to exit by selling off their shares. Shareholders are able to exercise their voting rights at a general meeting of shareholders to discipline management.[3] Let's assume the director X has not engaged in appropriate

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[1] See, e.g., Reinier H. Kraakman et al., *The Anatomy of Corporate Law* (3rd edn.: OUP, 2017) 29-32.

[2] See, e.g., Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (Rev. edn.: Harcourt, Brace & World, 1968).

[3] For a comparative examination of the functions of "voting" in the context of corporate governance, see, e.g., G. Hertig, *Convergence of Substantive Law and Convergence of Enforcement: A Comparison* (2004) 328-47in Jeffrey N. Gordon and Mark J. Roe, *Convergence and Persistence in Corporate Governance* (Cambridge: Cambridge University Press, 2004).

management practices for the good of the shareholders as a whole. Shareholders would be able to oppose the reappointment of director X or put up an alternative candidate to replace director X at a general meeting of shareholders. This power wielded by shareholders makes management aware of the possibility of being replaced if they fail to engage in management practices that fully satisfy the shareholders and encourages management to strive for proper management. Shareholders' appointment rights are the most important and fundamental means available for mitigating the agency problem.[4]

However, voting by shareholders does not always work as an effective means for fully disciplining management. In particular, listed companies and other companies with a large unspecified number of shareholders are faced with a collective action problem arising from dispersed shareholders.[5] Shareholders are required to duly monitor the business practices of the directors in order to effectively exercise their voting rights at general meetings, and this takes both time and money. Shareholders who spend the time and money to exercise their votes in a manner that effectively disciplines management may facilitate the maintenance and improvement of corporate value, but the benefits from the maintenance and improvement of corporate value are enjoyed by all shareholders. Shareholders who diligently monitor the management and vote merely receive a pro rata benefit based on their shareholding ratio regardless of the monitoring costs. From

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[4] E Ferran, *Company Law and Corporate Finance* (OUP, 1999), 118-22.

[5] Paul L. Davies, *Introduction to Company Law* (2nd edn.: OUP, 2010), 131.

another perspective, other shareholders are able to free ride off the voting efforts of specific shareholders.[6] Though shareholder voting is one of the most important means for mitigating the agency problem, this is limited by the free rider problem which neutralised any incentive for spending time and money to exercise votes.[7]

If a director fails to appropriately conduct business, instead of replacing the director through voting a shareholder is also able to exit by selling the company's shares to recover his/her investment. In particular, shareholders are able to easily dispose of shares in listed companies. A shareholder exit may demonstrate the following market mechanism to effectively discipline directors. For example, let's assume that direct X of company A is not engaged in appropriate business conduct and company's corporate value is not rising at a satisfactory level. In this case, the share price of the company A would slump if multiple shareholders were to sell their shares, and this may result in the situation in which the company fails to fully utilise its management resources and the share price declines below the company's potential corporate value. This would give rise to an arbitrage incentive for competitors or private equity funds who would have the option to launch a takeover bid (TOB) and grasp control over a company where the share price has declined below its potential. With seizing the company's control, they would be able to improve corporate value and increase the share price through the

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6 Ibid.

7 This is common phenomenon of "rational apathy." See, e.g., Robert Charles Clark, *Corporate Law* (Little, Brown, 1986), 390-2.

effective utilisation of the company's management resources. Success in these efforts could lead to a large payout. As such, the directors' failure to appropriately engage in business could evoke a slump in the share price through the exit of a large number of shareholders, and render the company susceptible to a hostile takeover. This market mechanism incentivises directors to pursue proper management.[8]

Nevertheless, this market mechanism has its limits. First, index funds, which are now the world's largest shareholders, cannot hold only the shares of specific listed companies and are required to hold a certain percentage of the shares of companies included in the indexes, which results in the loss of the exit option and weakens the disciplinary effect of the market mechanism over management. Next, directors are able to undermine the potential of hostile takeovers by enacting a variety of protectionist policies, which dilute the disciplinary effect of the market mechanism.[9] Additionally, the replacement of management through the seizure of a company's control is a drastic action which presents acquirers with significant costs and risks.[10] Accordingly, a company will not necessarily face a hostile

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[8] For the modern economic theory of the market for corporate control, see Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* (Harvard University Press, 1991).

[9] Arad Reisberg, *Derivative Actions and Corporate Governance* (OUP, 2007), 43.

[10] For discussions of huge cost of changing management by takeovers, see, e.g., Alan T. Peacock and Graham Bannock, *Corporate Takeovers and the Public Interest* (Aberdeen University Press, 1991).

takeover unless it allows its share price to fall to an excessively low level. Under these circumstances, it is uncertain as to just how much of an effect the market mechanism has on the disciplining of management.[11] Empirical research has also shown that the replacement of management is a rare occurrence.[12]

Voting at general meeting of shareholders or an exit through the sale off of shares may ultimately lead to the replacement of directors, but it requires a significant amount of effort by the shareholders and may cause managerial confusion at the company. A less radical, milder means of mitigating the agency problem would be preferable. One method is the establishment of proper incentives through a well-designed management remuneration package. This method is referred to as the "reward strategy".[13] This is designed to link the interests of shareholders and management by combining the payment of fixed cash remuneration with remuneration linked to short- and mid-term performance, share-based remuneration to incentivise the increase of corporate value over the mid- and long-term, and other incentives.[14] Nevertheless, remuneration-based

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[11] For detailed discussions, see Reisberg, *Derivative Actions and Corporate Governance* above n 9, 41-44.

[12] It has been pointed out that hostile takeover markets in the United Kingdom do not significantly react to poor management. See Julian Franks and Colin Mayer, 'Governance as a Source of Managerial Discipline', *IDEAS Working Paper Series from RePEc,* (2002).

[13] Kraakman et al., *The Anatomy of Corporate Law* above n 1, 36.

[14] In Japan, supplementary principle 4-2-1 of Corporate Governance Code stipulates that the board should design management remuneration systems such that they operate as a

incentives may also be detrimental in encouraging excessive risk taking.[15] Another possible strategy is the use of outside directors as agents for the monitoring of directors. This method is classified as the "trusteeship strategy".[16] While monitoring by shareholder voting is confronted by the collective action problem as described above, this strategy addresses the issue through monitoring by outside directors. However, there is still a possibility that the outside directors will collude with management.[17] There is also a possibility that the monitoring of management by outside directors is not fully incentivised. The recent study found no evidence of effective monitoring by outside directors.[18] Accordingly, neither the establishment of remuneration based incentives nor the monitoring of directors through the appointment of outside directors serves as a panacea.

Along with the methods we have observed so far, "regulatory strategies"

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healthy incentive to generate sustainable growth, and determine actual remuneration amounts appropriately through objective and transparent procedures, and also that the proportion of management remuneration linked to mid- to long-term results and the balance of cash and stock should be set appropriately.

[15] See, e.g., Bruno S. Frey and Felix Oberholzer-Gee, *The Cost of Price Incentives: An Empirical Analysis of Motivation Crowding-Out* (87, 1997) 746-55

[16] Kraakman et al., *The Anatomy of Corporate Law* above n 1, 62.

[17] For a suggestion that outside directors may be just "cosmetics" and that additional outside directors may reduce the company's value, see Anup Agrawal and Charles R. Knoeber, 'Firm Performance and Mechanisms to Control Agency Problems between Managers and Shareholders', *Journal of Finance,* 50/3 (1995), 943-43.

[18] Franks and Mayer, 'Governance as a Source of Managerial Discipline', above n 12.

play a key role in the mitigation of the agency problem. Regulatory strategies "dictate substantive terms that govern the content of the principal-agent relationship, tending to constrain the agent's behavior directly."[19] One such approach is to establish rules of conduct for directors under company law and impose liability for the breach of this conduct. Directors commonly owe a duty of loyalty and a duty of care in many jurisdictions,[20] and directors who fail to appropriately perform these duties can be liable to the company for the compensation of damages. The threat of this liability with the company encourages directors to conduct business in the best interests of the company.

Nevertheless, even if a director's duties and liability are prescribed under company law, the disciplinary effect of these provisions is not fully realised until they are enforced against a director who has engaged in misconduct. Provisions addressing director duties and liability require effective enforcement in order to truly function in the mitigation of agency costs. The question becomes how best to effectively enforce these provisions against directors. First, the right to bring an action on behalf of the company is usually amongst the responsibilities of the board of directors,[21] and that would be the case with seeking compensation for

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[19] Kraakman et al., *The Anatomy of Corporate Law* above n 1, 31,

[20] See, e.g., Andreas Cahn and David C. Donald, *Comparative Company Law : Text and Cases on the Laws Governing Corporations in Germany, the Uk and the USA* (Cambridge: Cambridge University Press, 2010), 332-68.

[21] Martin Gelter, 'Why Do Shareholder Derivative Suits Remain Rare in Continental Europe?', *Brooklyn Journal of International Law,* 37/3 (2012), 843 847. See Del. CODE.

damages from directors belongs to the company. As such any decision on whether to seek compensation for damages from ex-/current directors is made by the current board of directors. However, the decision by directors as to whether to seek enforcement against ex-/current directors gives rise to a conflict of interest. Directors may be motivated to go easy on enforcement in order to protect a colleague or due to concerns that strict enforcement may come back to haunt them, and this may lead to the lack of full enforcement even in those instances where enforcement would best option for the interests of all shareholders.[22] Even if director duties and liability are prescribed under company law, as long as the actual enforcement thereof is left to the directors, there is no guarantee that this will work as effective enforcement, and it is possible that this will not fully serve as effective discipline on management.

Derivative actions are a means for addressing this under-enforcement.[23] Derivative actions allow a shareholder to enforce the company's claims against

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ANN. tit. 8m § 141(a) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors....").

[22] Kenneth B. Davis, 'The Forgotten Derivative Suit', *Vanderbilt Law Review,* 61/2 (2008), 387-451, 397. Gelter, 'Why Do Shareholder Derivative Suits Remain Rare in Continental Europe?', above n 21, 847.

[23] Agostino v. Hicksm 845 A.2d 1110, 1116 Del. Ch. 2004) ("Recognizing, however, that directors and officers of a corporation may not hold themselves accountable to the corporation for their own wrongdoing, courts of equity have created an ingenious device to police the activities of corporate fiduciaries: the shareholder's derivative suit.").

director X on behalf of the company. If the company fails to fully address the misconduct of director X, a shareholder is able to secure effective enforcement on an exceptional basis through his/her power to bring suit for enforcement on behalf of the company.

1.4. Functions of Derivative Actions

The existence of derivative actions ensures the effectiveness of enforcement against directors. The question becomes just how much the filing of actions is encouraged by design under the derivative action system.[24] Consideration of this question requires analysis of the functions performed by derivative actions. Below I will look at the significance of the compensatory function, deterrence and the production of precedence/the production of legal rules identified as functions of derivative actions, and the conditions required for these functions to be exhibited.

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[24] For a detailed analysis, see, e.g., Reisberg, *Derivative Actions and Corporate Governance* above n 9, 46-74. See also R. Kraakman, H. Park, and S. Shavell, 'When Are Shareholder Suits in Shareholder Interests', *Georgetown Law Journal,* 82/5 (1994), 1733-75, 1738-39; James D. Cox, 'The Social Meaning of Shareholder Suits', *Brooklyn Law Review,* 65 (1999), 3-45, 8; Robert B. Thompson and Randall S. Thomas, 'The Public and Private Faces of Derivative Lawsuits', *Vanderbilt Law Review,* 57/5 (2004a), 1747-93, 1774; Jessica Erickson, 'Corporate Misconduct and the Perfect Storm of Shareholder Litigation', *Notre Dame Law Review,* 84/1 (2008), 75-130, 102.

1.4.1. Compensatory Function

In theory, one function of derivative actions is the compensation of the damages suffered by a company due to the misconduct of directors.[25] However, in reality, and specifically in the case of listed companies, the compensatory function of derivative actions is marginal.[26] First, in the case of large listed or unlisted companies, the companies engage in economic activities on a large scale and the damages they suffer tend also be large in nature. Conversely, defendant directors are individuals with limited resources. As such, even if a plaintiff shareholder prevails in a derivative action and the defendant director is ordered to pay a large amount of compensation, it is very likely that the amount actually paid to the company will be only a small portion of the awarded damages.[27] If D&O insurance is utilised, recovery is limited to the amount paid out under this insurance. Furthermore, the company essentially pays the D&O insurance premiums so the

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[25] Reisberg, *Derivative Actions and Corporate Governance* , above n 9, 56.

[26] Takahito Kato, 'Guroup Kigyou No Kisei-Houhou Ni Kansuru Ichikosatsu (3) [an Inquiry into Legal Measures for Regulating Corporate Groups (3)]', *Hougaku Kyoukai Zasshi,* 129/10 (2012/10 2012b), 2203-318, 2204-05; YōIchi Takahashi, *Tajū Daihyō Soshō Seido No Arikata : HitsuyōSei to Seido Sekkei [Design of Double Derivative Actions-the Need and System Design-]* (1st edn.: Shōji Hōmu, 2015), 150-151.

[27] Takahashi, *Tajū Daihyō Soshō Seido No Arikata : HitsuyōSei to Seido Sekkei [Design of Double Derivative Actions-the Need and System Design-]* , above n 26, 151; John C. Coffee and Donald E. Schwartz, 'The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform', *Columbia Law Review,* 81/2 (1981), 261-336, 304-5.

compensatory function must account for the burden of these premium payments. In particular, if the payment of insurance money directly leads to an increase in future premiums, essentially the expected compensatory function will be zeroed out.[28]

Second, the plaintiff shareholder receives next to no benefit from the compensation. Even when a plaintiff shareholder prevails in a derivative action, the defendant director compensates the company, and only the company's damages are compensated. Individual shareholders are not directly compensated in derivative actions. The plaintiff shareholder's award is limited to pro rata compensation based on his/her shareholding ratio.[29] In the case of a listed company, the plaintiff shareholder will only earn negligible amount of

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[28] John C. Coffee, 'Litigation and Corporate Governance: An Essay on Steering between Scylla and Charybdis', *Geo. Wash. L. Rev.,* 52 (1984), 805-806; Kraakman, Park, and Shavell, 'When Are Shareholder Suits in Shareholder Interests', above n 24, 1746. 1765-66; Davis, 'The Forgotten Derivative Suit', above n 22, 412; Randall Thomas and R. B. Thompson, 'Empirical Studies of Representative Litigation', in Claire A. Hill and Brett H. Mcdonnell (eds.), *Research Handbook on the Economics of Corporate Law* (2012), 152-69, 156.

[29] Reisberg, *Derivative Actions and Corporate Governance* , above n 9, 222; Stephen P. Ferris et al., 'Derivative Lawsuits as a Corporate Governance Mechanism: Empirical Evidence on Board Changes Surrounding Filings', *Journal Of Financial And Quantitative Analysis,* 42/1 (2007), 143-65, 146.

compensation per share.[30] Additionally, the risk of future repeated wrongdoing by directors is reflected in the share price, and the losses suffered by a shareholder from the decline in the share price may outpace the compensation per share.[31]

Third, a company may suffer losses in excess of the amount of compensation. The filing of a derivative action may negatively impact a company's reputation. A company's internal information may become public in the course of the litigation. Responding to litigation takes time and money. And a derivative action may have a chilling effect on future management decisions. A company incurs various litigation costs once a derivative action is filed, and the compensatory function is diminished by these costs. In some cases the costs can exceed the amount of compensation.[32]

1.4.2. Deterrence

As addressed above, the actual significance of the compensatory function of

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[30] For empirical studies showing that plaintiff shareholders receive only a marginal gain in the United States, see Roberta Romano, 'The Shareholder Suit: Litigation without Foundation?', *The Journal of Law, Economics, and Organization,* 7/1 (1991), 55-87, 62.

[31] Coffee and Schwartz, 'The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform', above n 27, 304.

[32] For detailed discussions regarding litigation costs, see Reisberg, *Derivative Actions and Corporate Governance* , above n 9, 47-50; Coffee and Schwartz, 'The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform', above n 27, 304.

derivative actions is limited at best. The real significance comes from deterrence.[33] Deterrence must be separately considered in terms of specific deterrence and general deterrence.[34] Specific deterrence indicates enforcement against a director who has engaged in misconduct in order to deter that director from engaging in wrongdoing again in the future.[35] General deterrence, on the other hand, indicates the deterrence of wrongdoing for society as a whole and not just at the company where a derivative action is filed. Also, general deterrence has a negative effect of deterring wrongdoing through the threat of enforcement and a positive effect of enhancing the general awareness of directors.[36] It has

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[33] Kato, 'Guroup Kigyou No Kisei-Houhou Ni Kansuru Ichikosatsu (3) [an Inquiry into Legal Measures for Regulating Corporate Groups (3)]', above n 26, 2204-05. For discussions as for the deterrence role of derivative actions, see, e.g., Daniel R. Fischel and Michael Bradley, 'The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis', *The Role of Liability Rules and the Derivative Suit in Corporate Law,* 71 (1986), 261-83; Donald E. Schwartz, 'In Praise of Derivative Suits: A Commentary on the Paper of Professors Fischel and Bradley', *Cornell L. Rev.,* 71 (1986); James D. Cox, Randall S. Thomas, and Dana Kiku, 'Sec Enforcement Heuristics: An Empirical Inquiry', *Duke Law Journal,* 53/2 (2003), 737-79; Thompson and Thomas, 'The Public and Private Faces of Derivative Lawsuits', above n 24, 1775.

[34] Coffee and Schwartz, 'The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform', above n 27, 308; Romano, 'The Shareholder Suit: Litigation without Foundation?', above n 30, 84-5.

[35] Romano, 'The Shareholder Suit: Litigation without Foundation?', above n 30, 84.

[36] Melvin A. Eisenberg, 'Corporate Law and Social Norms', *Columbia Law Review,* 99 (1999) 1253, 1266-71.

been identified that in the United States, where derivative actions are actively utilised, even if the actions have not lead to compensation, they have changed social norms through the clarification of the duty of care, and increased the level of care exercised by directors.[37]

1.4.3. Incentive Problem

For listed companies, deterrence is the major function of derivative actions. However, in order to ensure the effectiveness of deterrence, a number of preconditions must be satisfied. The most important of these is the existence of a real prospect of the filing of a derivative action when wrongdoing occurs.[38] Deterrence arises from the prospect of litigation,[39] and does not require that an action be filed when wrongdoing occurs. However, there must be a general recognition of a real prospect of the filing of a derivative action by a shareholder if a director is in breach of his/her duties. Specifically, the realisation of a general

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[37] Ibid.

[38] Kato, 'Guroup Kigyou No Kisei-Houhou Ni Kansuru Ichikosatsu (3) [an Inquiry into Legal Measures for Regulating Corporate Groups (3)]', above n 33) 2211; Kraakman, Park, and Shavell, 'When Are Shareholder Suits in Shareholder Interests', above n 24, 1738; Jessica Erickson, 'Corporate Governance in the Courtroom: An Empirical Analysis', *William & Mary Law Review,* 51 (2010), 1749, 1828.

[39] Kraakman, Park, and Shavell, 'When Are Shareholder Suits in Shareholder Interests', above n 24, 1738.

deterrence effect requires a certain number of actual derivative action cases where the plaintiff shareholders prevail and the defendant directors are ordered to pay compensation.[40]

What is important in ensuring a real prospect of litigation is the issue of incentive for plaintiff shareholders and their attorneys.[41] The incentive issue must be overcome to encourage the filing of derivative actions when needed. This must give dual consideration to the removal of disincentives and the securing of incentives.[42] Firstly, an important issue in the removal of disincentives is the burden of the expenses paid to the court in the filing of an action.[43] Hefty court fees in the filing of an action will function as a factor dissuading plaintiff shareholders from pursuing action.[44] There is also the issue of assigning the costs

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[40] Ibid.

[41] Kato, 'Guroup Kigyou No Kisei-Houhou Ni Kansuru Ichikosatsu (3) [an Inquiry into Legal Measures for Regulating Corporate Groups (3)]', above n 26, 2211.

[42] John E. Parkinson, *Corporate Power and Responsibility : Issues in the Theory of Company Law* (Oxford : Clarendon, 1993)241; Reisberg, *Derivative Actions and Corporate Governance* , above n 9, 232-3 ("Removing a deterrent is simply not the same as providing an incentive.").

[43] For an analysis focusing on the Japanese experience, see Mark D. West, 'Why Shareholders Sue: The Evidence from Japan', *The Journal of Legal Studies,* 30/2 (2001), 351-82. See also Mark D. West, 'The Pricing of Shareholder Derivative Actions in Japan and the United-States', *Northwestern University Law Review,* 88/4 (1994), 1436-507.

[44] West, 'Why Shareholders Sue: The Evidence from Japan', above n 43, 380-81.

of litigation to the losing party, as the English rule.[45] If a plaintiff shareholder is burdened with the court costs as well as the costs incurred by the defendant director and the company when losing a derivative action, he/she must be concerned with the risk of the costs when losing in court. This would result in hesitancy of would-be plaintiff shareholders to pursue action in cases where the outcome is uncertain, and shareholders will be unwilling to pursue derivative actions unless this disincentive is removed.[46]

Next, the economic free rider problem must be addressed to ensure incentives.[47] Compensation is awarded to the company and not the plaintiff shareholder when a plaintiff shareholder prevails in a derivative action. A plaintiff shareholder is only awarded pro rata compensation based on his/her shareholding ratio. Any disciplinary effect on future management or improvement of corporate value arising from a derivative action is enjoyed by all shareholders, and the plaintiff shareholder will only receive a pro rata benefit based on his/her shareholding ratio. The plaintiff shareholder exerts all the time and effort for filing a derivative action but only earns a pro rata benefit when prevailing. As a result thereof, in many cases the costs of bringing a derivative action outweigh the benefits, and there is little incentive for pursuing action. This is

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[45] Reisberg, *Derivative Actions and Corporate Governance* , above n 9, 226.

[46] Ibid.

[47] For an empirical evidence of the free-rider problem, see Romano, 'The Shareholder Suit: Litigation without Foundation?', above n 30, 62.

typical of the economic free rider problem. Derivative actions are structured so that would-be plaintiff shareholders encounter this free rider problem, and unless something is done, shareholders will have no incentive to pursue derivative actions in the future even when enforcement is necessary. As long as nothing is done there will be no real likeliness of derivative actions and no deterrence. Accordingly, incentives must be secured to stimulate the filing of derivative actions.[48]

The economic incentives for plaintiff's attorneys are also a key factor in considering incentives for the filing of actions.[49] In particular, the establishment of a fee system which allows for contingency fees and burdens the company with the prevailing plaintiff's attorney's fees will give rise to economic incentives which lead to the filing of derivative actions.[50]

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[48] Arad Reisberg, 'Funding Derivative Actions: A Re-Examination of Costs and Fees as Incentives to Commence Litigation', *Journal of Corporate Law Studies,* 4/2 (2004), 345-83 347-48.

[49] For discussions regarding plaintiff lawyers' incentives, see John C. Coffee, 'The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation', *Law and Contemporary Problems,* 48/3 (1985), 5-81.

[50] See generally Bernard Black, Brian Cheffins, and Michael Klausner, 'Outside Director Liability', *Stanford Law Review,* 58/4 (2006), 1055-159, 1097-1122; Brian Cheffins and Bernard Black, 'Outside Director Liability across Countries', *Texas Law Review,* 84/6 (2006), 1385-480, 1465; Kato, 'Guroup Kigyou No Kisei-Houhou Ni Kansuru Ichikosatsu (3) [an Inquiry into Legal Measures for Regulating Corporate Groups (3)]', above n 26, 2211-12.

1.4.4. Necessity of Trust in the System

Derivative actions must secure a reputation and trust as a tool of corporate governance to facilitate effective deterrence.[51] The general deterrence of derivative actions arises not only from prospect of incurring an obligation for compensation if losing the case but also from the social disgrace of becoming a defendant director.[52] This reputation based general deterrence requires society trust in derivative actions as effective tools for corporate governance.[53] There is a possibility that if derivative actions are widely abused, the social disgrace of becoming a defendant director will decline and deterrence will wane.[54]

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[51] Kato, 'Guroup Kigyou No Kisei-Houhou Ni Kansuru Ichikosatsu (3) [an Inquiry into Legal Measures for Regulating Corporate Groups (3)]', above n 26, 2211.

[52] Cox, 'The Social Meaning of Shareholder Suits', above n 24, 5; Erickson, 'Corporate Governance in the Courtroom: An Empirical Analysis', above n 38, 1826-27. See generally A. Eisenberg, 'Corporate Law and Social Norms', above n 36, 1276.

[53] See generally David A. Skeel, 'Shaming in Corporate Law', *University of Pennsylvania Law Review,* 149/6 (2001), 1811-68, 1849; A. Eisenberg, 'Corporate Law and Social Norms', above n 36, 1276.

[54] Erickson, 'Corporate Governance in the Courtroom: An Empirical Analysis', above n 38, 1827; Cox, 'The Social Meaning of Shareholder Suits', above n 24, 6; Kato, 'Guroup Kigyou No Kisei-Houhou Ni Kansuru Ichikosatsu (3) [an Inquiry into Legal Measures for Regulating Corporate Groups (3)]', above n 26, 2214; Takahashi, *Tajū Daihyō Soshō Seido No Arikata : HitsuyōSei to Seido Sekkei [Design of Double Derivative Actions-the Need and System Design-]* , above n 26, 157.

The securing of social trust in derivative actions is also related to the mitigation of the incentive issues. If a framework is not put into place to secure the economic incentives of plaintiff shareholders, it is possible that shareholders will be motivated to file derivative actions for individual interests and not the interests of shareholders as a whole.[55] Such suspicions are at risk of reducing the social trust in derivative actions and impairing deterrence.[56] In particular, if a defendant in a derivative action ends up being considered a victim of abuse instead of someone who has engaged in misconduct, derivative actions will no longer function to diminish trust in the defendant directors and will no longer function as deterrence.[57]

1.4.5. Mitigation of Abuse of Derivative Actions - the Need for the Right Balance

As addressed above, what are needed for derivative actions to function as a general deterrence are constraints on abuse of the system while preserving the incentives

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[55] Kato, 'Guroup Kigyou No Kisei-Houhou Ni Kansuru Ichikosatsu (3) [an Inquiry into Legal Measures for Regulating Corporate Groups (3)]', above n 26, 2211.

[56] Ibid.

[57] Erickson, 'Corporate Governance in the Courtroom: An Empirical Analysis', above n 38, 129; Cox, 'The Social Meaning of Shareholder Suits', above n 24, 6; Kato, 'Guroup Kigyou No Kisei-Houhou Ni Kansuru Ichikosatsu (3) [an Inquiry into Legal Measures for Regulating Corporate Groups (3)]', above n 26, 2211.

for bringing adequate actions. These demands are contradictory and difficult to address. In particular, as you will see below, making derivative actions easily available has the adverse effect if generating a new another agency problem, i.e. the litigation costs arising from the conflicts of interest between the plaintiff shareholders and the other shareholders.[58]

Capital majority decision making is a basic principle of corporate law, and a director who is elected by a majority vote of the shareholders is entrusted with the management of the company and the authority to dispose of the assets belonging to the company. A company owns any claim against a director for the compensation of damages, and the decision of how to deal with such a claim is left to the directors. Indeed, the basic principle is that a majority shareholder decision will govern. Contrary to this principle, a derivative action allows an individual shareholder to bring an action against a director on behalf of the company without any determination being made by the directors elected by a majority of shareholders, i.e. it is an exception to the principle of capital majority decision making.

A principal and agent relationship exists in an economic analysis of the structure of derivative actions.[59] Derivative actions are structured so that the

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[58] John C. Coffee, 'Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law through Class and Derivative Actions', *Columbia Law Review,* 86/4 (1986), 669-727, 679-80.

[59] Romano, 'The Shareholder Suit: Litigation without Foundation?', above n 30, 55.

enforcement of rights against a company's directors is entrusted to the plaintiff shareholder, and under this structure the company, namely all of its shareholders, becomes the principal and the plaintiff shareholder acts as its the agent. Such a structure gives rise to a conflict of interest between the shareholders in general and the plaintiff shareholder.[60] For example, there may be problems regarding the appropriateness of the plaintiff shareholder's motive for bringing action.[61] We have long been aware of the risk of strike suits where plaintiff shareholders seek to exploit derivative actions in an effort to unjustly gain personal benefits.[62] In principle, when determining whether or not to bring an action, a plaintiff shareholder would take into consideration the possibility of success in the action, the likeliness of recovering damages, the burden incurred by the company in responding to the action, reputation risks, and whether there will be an excessive chilling effect on management in the future and should otherwise take into consideration in general the question of whether a derivative action will work the benefit of all shareholders. However, the plaintiff shareholder may lack the

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[60] David Webber, 'Private Policing of Mergers and Acquisitions: An Empirical Assessment of Institutional Lead Plaintiffs in Transactional Class and Derivative Actions', *Delaware Journal of Corporate Law,* 38/3 (2014), 907-82, 923.

[61] Fischel and Bradley, 'The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis', above n 33, 271.

[62] Henry W. Ballantine, 'Abuses of Shareholders Derivative Suits: How Far Is California's New "Security for Expenses" Act Sound Regulation?', *California Law Review,* 37/3 (1949), 399-418.

incentive, ability and information to make a comprehensive determination of these factors.[63] As a result, there is a risk that derivative actions will be filed even in those instances where the action is unnecessary for the benefit of all shareholders. Conversely, there is a risk that a plaintiff shareholder will lack the sufficient expertise, experience, skills and information to appropriately file and pursue a derivative action even if such an action is determined necessary for the benefit of all shareholders. There is also a risk of collusion between the plaintiff shareholder and the defendant director[64]. All of these risks arise in the principal company's entrustment of the enforcement of rights of claims against directors for damages to the agent plaintiff shareholder. The self-selection aspect of plaintiff shareholders makes the agency problem of derivative actions all the more prominent.[65] While derivative actions function to mitigate managerial agency costs, a side effect thereof is the creation of a new agency problem between the plaintiff shareholder and the other shareholders, and this agency problem may serve as a factor in the disassociation of the interests of the plaintiff shareholder

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[63] Fischel and Bradley, 'The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis', above n 33, 271.

[64] For a suggestion of the possibility of collusive settlements, see John C. Coffee, 'Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working', *Maryland Law Review,* 42/2 (1983), 215-88, 232.

[65] James D. Cox and Randall Thomas, 'Corporate Darwinism: Disciplining Managers in a World with Weak Shareholder Litigation', *North Carolina Law Review,* 95 (2016), 19-66, 22.

from the interests of the company and the undermining of confidence in the derivative action system as pointed out above.

A structural conflict of interest accompanying derivative actions also arises between the interests of the plaintiff shareholder's attorneys and interests of all shareholders.[66] The introduction of a contingency fee system and the placing of the burden of the attorneys' fees on the company would give rise to an economic incentive for plaintiffs' attorneys who would likely then serve as lead players in derivative actions.[67] However, if this goes too far, there is a risk of that a conflict of interest will arise between the interests of the plaintiff shareholder's attorneys and interests of all shareholders, and this conflict of interest has been identified as a factor in the abusive exploitation of derivative actions and securities litigation[68].

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[66] See generally Macey, Jr. and G. P. Miller, 'The Plaintiffs Attorneys Role in Class-Action and Derivative Litigation - Economic-Analysis and Recommendations for Reform', *University Of Chicago Law Review,* 58/1 (1991a), 1-118.

[67] See generally Black, Cheffins, and Klausner, 'Outside Director Liability', above n 50, 1097-1122; Cheffins and Black, 'Outside Director Liability across Countries', , above n 50, 1465; Kato, 'Guroup Kigyou No Kisei-Houhou Ni Kansuru Ichikosatsu (3) [an Inquiry into Legal Measures for Regulating Corporate Groups (3)]', above n 26, 2211-12.

[68] Coffee, 'Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law through Class and Derivative Actions', above n 58, 679-80; Macey and Miller, 'The Plaintiffs Attorneys Role in Class-Action and Derivative Litigation - Economic-Analysis and Recommendations for Reform', above n 66, 22; Romano, 'The Shareholder Suit: Litigation without Foundation?', above n 30; Mark J. Loewenstein, 'Shareholder Derivative Litigation and Corporate Governance', *Delaware Journal of Corporate Law,* 24 (1998), 1-26, 2; Robert B. Thompson and Randall S. Thomas,

As such, the biggest issue in ensuring the general deterrence of derivative actions is the creation of a mechanism that addresses the incentive problems faced by plaintiff shareholders who bring actions and their attorneys while simultaneously constraining the filing of actions that run contrary to the interests of the shareholders as a whole, and the right balance must be found between promotional measures and restraint measures.

1.4.6. Expectation to Derivative Actions

Here I would like to address whether there is any necessary or obvious demand for derivative actions to have as strong deterrence function. The following two points must be taken into consideration in making a determination of how much the deterrence of derivative actions should be emphasised as a response to the agency problem between directors and shareholders. One is that the general deterrence of derivative actions is a "public good" having positive "externality", and the other is that the need for a derivative action should be examined in a mutually complementary relationship with other legal or governance strategies.

Firstly, the deterrence arising from derivative actions is regarded as a

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'The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions', *Vanderbilt Law Review,* 57/1 (2004b), 133, 152-57; Erickson, 'Corporate Misconduct and the Perfect Storm of Shareholder Litigation', above n 24,101; Thomas and Thompson, 'Empirical Studies of Representative Litigation'. above n 28, 154-55.

“public good” in terms of economics.[69] A realistic probability of a derivative action works as a general deterrence on director misconduct, and that function does not merely affect the company where the action is brought. Once a derivative action is brought at a company, directors at other companies become conscious that the shareholders may pursue action if they fail to properly engage in the management of the company. This general deterrence benefits corporate society in general and is enjoyed by shareholders at other companies as well.[70] Also, deterring wrongdoings that cause damages to a company benefits the company’s creditors and employees.[71] Furthermore, it promotes legal compliance, protects those consumers’ interests protected by law, encourages compliance with environmental regulations, and otherwise benefits a wide array of stakeholders.[72] As such, the effective general deterrence of derivative actions widely benefits society as a whole. This is why the general deterrence of derivative actions has

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[69] Romano, 'The Shareholder Suit: Litigation without Foundation?', above n 30, 85; Davis, 'The Forgotten Derivative Suit', above n 22, 70-79.

[70] Coffee and Schwartz, 'The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform', above n 27, 308; Kraakman, Park, and Shavell, 'When Are Shareholder Suits in Shareholder Interests', above n 24, 1756; Cox, 'The Social Meaning of Shareholder Suits', above n 24, 271; Thompson and Thomas, 'The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions', above n 68, 143.

[71] Kato, 'Guroup Kigyou No Kisei-Houhou Ni Kansuru Ichikosatsu (3) [an Inquiry into Legal Measures for Regulating Corporate Groups (3)]', above n 26, 155.

[72] Ibid.

been identified, in nature, to be a public good.[73] This general deterrence extends beyond the company where a derivative action is filed to benefit society as a whole, and this public function could be argued to be a "positive externality".[74]

This nature of general deterrence also involves a value judgment on just how much the deterrence of derivative actions should be emphasised in context of corporate governance. While the deterrence of derivative actions may benefit society in whole, the company subject to the action incurs a variety of costs through a loss of reputation, the burden of responding to the action, and the chilling effect on management in the future.[75] The general deterrence places a burden on the shareholders of the company where a derivative action is brought while benefiting society in whole. If this benefit to society as a whole is excluded from consideration, for the company subject to the derivative action the costs accompanying, this action may outweigh any benefits from the recovery of damages or the specific deterrence arising from that action.[76] It also remains uncertain as to whether it is socially preferable to force the costs of a derivative action on a specific company in order to realise a general deterrence on the

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[73] Davis, 'The Forgotten Derivative Suit', above n 22, 70-79.

[74] Kraakman, Park, and Shavell, 'When Are Shareholder Suits in Shareholder Interests', above n 24, 1755.

[75] Reisberg, *Derivative Actions and Corporate Governance* , above n 9, 47-50.

[76] Kato, 'Guroup Kigyou No Kisei-Houhou Ni Kansuru Ichikosatsu (3) [an Inquiry into Legal Measures for Regulating Corporate Groups (3)]', above n 26, 2209.

management of other companies.[77] The question becomes how this should be taken into consideration when examining the design of the derivative action system.

Secondly, examination of the question of just how much should be expected of the deterrence from derivative actions must take into consideration how this deterrence complements other mechanisms.[78] For example, in the case of the deterrence of illegal activity, criminal prosecution, administrative sanctions and other state enforcement also works as a general deterrence.[79] In addition, activist funds and other institutional investors may exercise their voting rights to mitigate the agency problem between directors and shareholders.[80] Additionally,

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[77] Coffee and Schwartz, 'The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform', above n 27, 307-09; Cox, 'The Social Meaning of Shareholder Suits', above n 24, 8-13; Davis, 'The Forgotten Derivative Suit', above n 22, 433-39; Erickson, 'Corporate Misconduct and the Perfect Storm of Shareholder Litigation', above n 24, 102-16; Kato, 'Guroup Kigyou No Kisei-Houhou Ni Kansuru Ichikosatsu (3) [an Inquiry into Legal Measures for Regulating Corporate Groups (3)]', above n 26, 2209-10.

[78] See generally John Armour et al., 'Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States', *Journal of Empirical Legal Studies,* 6/4 (2009), 687-722.

[79] See generally John Armour, 'Enforcement Strategies in Uk Corporate Governance: A Roadmap and Empirical Assessment', *ECGI-Law Worling Paper,* 106 (2008).

[80] See generally Ronald J. Gilson and Jeffrey N. Gordon, 'The Rise of Agency Capitalism and the Role of Shareholder Activists in Making It Work', *Journal of Applied Corporate Finance,* 31/1 (2019), 8-22; Ronald Gilson and Jeffrey Gordon, 'The Agency Costs of

there are "reward strategies" that utilise director remuneration and "trusteeship strategies" which seek out oversight from outside directors.[81] Market mechanisms which offer the shareholders an exit opportunity also have a disciplinary effect.[82] Another disciplinary effect comes from the reputation of management in the labor market and the industry. Based on the costs incurred by companies in derivative actions and the conflicts of interests that arise between the plaintiff shareholders and other shareholders, increasing the number of derivative actions does not necessarily mean that there will be a more desirable effect, and effective means of achieving this purpose with lower costs would be preferred.[83] Derivative actions are just one method for mitigating the agency problem between directors and shareholders.[84]

1.4.7. Production of Precedent/Legal Rules

Agency Capitalism: Activist Investors and the Revaluation of Governance Rights', *Columbia Law Review,* 113/4 (2013), 863-927.

[81] Kraakman et al., *The Anatomy of Corporate Law* above n 1, 36 and 62.

[82] See generally Easterbrook and Fischel, *The Economic Structure of Corporate Law* , above n 8.

[83] Kristoffel Grechenig and Michael Sekyra, 'No Derivative Shareholder Suits in Europe: A Model of Percentage Limits and Collusion', *International Review of Law & Economics,* 31/1 (2011), 16-20, 20.

[84] Kato, 'Guroup Kigyou No Kisei-Houhou Ni Kansuru Ichikosatsu (3) [an Inquiry into Legal Measures for Regulating Corporate Groups (3)]', above n 26, 2207.

Derivative actions also function to create legal rules regarding the duties and responsibilities of directors.[85] The accumulation of court judgments in derivative action cases will produce precedent and bring clarity to the interpretation of law.[86] Additionally, derivative actions function to inspire discussion by experts and to promote debate regarding rules of conduct for directors.[87] Once the details of the duties owed by a director to a company are clarified in a derivative action, these details are spread to the directors at other companies through the advice provided by attorneys and other professionals.[88] Clarification of the legal rules not only deters future illegal behavior, it also has the advantage of drawing a clear line between what is legal and what is not without having an overly chilling effect on directors.[89] These legal rules are developed through cases in which the plaintiff

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[85] Romano, 'The Shareholder Suit: Litigation without Foundation?', above n 30, 85; A. Eisenberg, 'Corporate Law and Social Norms', above n 36, 1277; Thompson and Thomas, 'The Public and Private Faces of Derivative Lawsuits', above n 24, 1749; Davis, 'The Forgotten Derivative Suit', above n 22, 435-38; Takahashi, *Tajū Daihyō Soshō Seido No Arikata : HitsuyōSei to Seido Sekkei [Design of Double Derivative Actions-the Need and System Design-]* , above n 26, 157.

[86] Cox, 'The Social Meaning of Shareholder Suits', above n 24, 18-9.

[87] Davis, 'The Forgotten Derivative Suit', above n 22, 437.

[88] Kato, 'Guroup Kigyou No Kisei-Houhou Ni Kansuru Ichikosatsu (3) [an Inquiry into Legal Measures for Regulating Corporate Groups (3)]', above n 26, 2232. See generally Edward B. Rock, 'Saints and Sinners: How Does Delaware Corporate Law Work?', *Ucla Law Review,* 44/4 (1997), 1009-107.

[89] Romano, 'The Shareholder Suit: Litigation without Foundation?', above n 30, 85.

shareholders prevail as well as cases where the plaintiff shareholders suffer defeat.[90]

Along with deterrence, the production of legal rules has important significance as a function of derivative actions. However, what must be noted is that like with deterrence, the benefits from the production of legal rules extend beyond the companies where derivative actions are filed to benefit society in general. With regard to this, the production of legal rules functions as a "positive externality" and serves, in nature, as a "public good".[91] Accordingly, as with deterrence, the key question becomes whether placing a burden on the shareholders of a company where a derivative action is filed should be positively valued for its function of producing legal rules.

1.5. Mechanisms for Reaching the Right Balance

As revealed above, derivative actions function to recover damages, deter future wrongdoing and produce legal rules. Plaintiff shareholders and their attorneys must be provided incentives to bring actions in order for these functions to be demonstrated. At the same time, derivative actions create a conflict of interest

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90 Takahashi, *Tajū Daihyō Soshō Seido No Arikata : HitsuyōSei to Seido Sekkei [Design of Double Derivative Actions-the Need and System Design-]* , above n 26, 160.

91 A. Eisenberg, 'Corporate Law and Social Norms', above n 36, 1278; Davis, 'The Forgotten Derivative Suit', above n 22, 437.

between the plaintiff shareholders and the other shareholders, and the risk of abuse is a side effect of encouraging the use of derivative actions. Accordingly, mechanisms for the promotion of appropriate derivative actions and the deterrence of inappropriate derivative actions are required in the design of the derivative action system.

The question becomes which derivative actions are inappropriate, or more precisely, which derivative actions should be dismissed as inappropriate. This question has been debated in terms of an abuse of derivative actions, and two types of abuse have been identified.[92] One is the filing of actions by plaintiff shareholders who clearly know there is no legal basis for the filing or the exploitation of derivative actions by plaintiff shareholders as a means to gain unjust benefits. These are known as strike suits, and unquestionably we should seek to deter frivolous strike suits.

The second type of identified abuse, while not necessarily falling under the first time, is derivative actions that do not benefit shareholders as a whole.[93]

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[92] Kenichi Osugi, 'Kabunushi-Daihyou-Soshou No Ranyou Heno Taisho [Response to Abuse of Derivative Actions]', *Hanrei Times,* 1066 (2001), 50-63, 51; Tomotaka Fujita, 'Kabunushi Daihyou Soshou No Gendaiteki Tenkai [the Modern Development of Derivative Actions]', in Shiro Kawashima and Masafumi Nakahigashi (eds.), *Kaisha-Jiken-Tetsudsukihou No Gendaiteki Tenkai [the Modern Development of the Procedural Law on Commercial Cases]* (1st edn.: Nihon-hyouron-sha, 2013a), 41, 42.

[93] Fujita, 'Kabunushi Daihyou Soshou No Gendaiteki Tenkai [the Modern Development of Derivative Actions]'. above n 92, 42.

For example, there are instances where the benefits gained by the company from the filing of an action, taking into comprehensive consideration to the plaintiff shareholder's likeliness of prevailing, the amount recoverable from the defendant director, the costs incurred by the company and other factors, will be outweighed by the costs of the action. Such instances have been identified as forming a unique abuse of derivative actions in the sense that the derivative action is not for the interests of shareholders as a whole.[94] There is also an opinion that those instances where the plaintiff shareholder does not have an unjust purpose for pursuing an action, but the company decides based on a comprehensive consideration of the various circumstances that the pursuant of liability against the director is inappropriate, are viewed as inappropriate derivative actions even if they do not extend to abuse.[95] This opinion seizes on the structural conflict of interest between the plaintiff shareholders and other shareholders in derivative actions to determine abusive or inappropriate actions. In other words, this opinion envisions the sorting out inappropriate actions from necessary actions based on the question of "whether the derivative action will benefit the interests of shareholders as a whole?"

However, the difficulty of emphasising the question of "whether the

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[94] Ibid.

[95] Masashi Kitamura, 'Koporeto Gabanansu to Kabunushi-Daihyou-Soshou [Corporate Governance and Derivative Actions]', in Hideyuki Kobayashi and Kondoh Mitsuo (eds.), *Shinban Kabunushi-Daihyou-Soshou Taikei [the New Anthology of Derivative Actions]* (Koubundou, 2002), 34, 47-8.

derivative action will benefit all shareholders?" would possibly be the failure to look at the bulk of the effects of derivative actions. Derivative actions function to facilitate the recovery of damages, to present a specific deterrence and general deterrence, and to produce legal rules. The only functions that have a direct benefit on the shareholders of a company where a derivative action is filed are the recovery of damages and specific deterrence, and the recovery of damages only has a marginal benefit according to the defendant director's resources.[96] Specific deterrence is also difficult to evaluate on a quantitative basis.[97] Additionally, if a derivative action is accompanied by criminal punishment, administrative punishment or other public enforcement, questions remain as to just how much an additional effect specific deterrence from the filing of a derivative action will have above and beyond this enforcement.[98] Meanwhile the benefits from general deterrence and the production of legal rules extend beyond the company to society in general. The more important function played by derivative actions is likely its

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[96] Kato, 'Guroup Kigyou No Kisei-Houhou Ni Kansuru Ichikosatsu (3) [an Inquiry into Legal Measures for Regulating Corporate Groups (3)]', , above n 26, 2204-05; Takahashi, *Tajū Daihyō Soshō Seido No Arikata : HitsuyōSei to Seido Sekkei [Design of Double Derivative Actions-the Need and System Design-]* , above n 26, 150-151.

[97] Thompson and Thomas, 'The Public and Private Faces of Derivative Lawsuits', above n 24, 1775; Cox, 'The Social Meaning of Shareholder Suits', above n 24, 19.

[98] Kraakman, Park, and Shavell, 'When Are Shareholder Suits in Shareholder Interests', above n 24, 1763; Davis, 'The Forgotten Derivative Suit', above n 22, 428; Erickson, 'Corporate Misconduct and the Perfect Storm of Shareholder Litigation', above n 24, 125-27.

effect as a "public good." Nevertheless, general deterrence and the production of legal rules can hardly be regarded as "benefits for the shareholders of the company where the action is filed." As such, the sorting out of derivative actions based on the standard of benefit for all shareholders fails to take these effects as "positive externalities" into consideration, and tends to result in judgments that underestimate the benefits and overemphasise the costs to the company from the action.

Judgments based on the interests to shareholders as a whole are expected to increase the number of derivative actions subject to dismissal, and there is concern that this will substantially nullify the function of derivative actions in serving as a general deterrence and producing legal rules. In nature, these functions serve as a "public good" and "positive externality." As such, it can be reasonably determined that individual companies will have a free-rider option where they do not allow derivative actions at their own companies but enjoy the deterrence and production of legal rules produced in derivative actions at other companies.[99] Derivative actions will no longer be filed if a majority of companies adopt this free-rider option. As a result, there will be no real prospect for the filing of derivative actions when misconduct occurs, and the general deterrence of

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[99] Takahashi, *Tajū Daihyō Soshō Seido No Arikata : HitsuyōSei to Seido Sekkei [Design of Double Derivative Actions-the Need and System Design-]* , above n 26, 178; Takashi Iida, 'Shakai-Teki Jirenma to Koukyouzai [Social Dillemma and Public Goods]', *Hougaku Kyoushitsu,* 398 (2013), 62, 62-3.

derivative actions will fail on its premise. Legal rules cannot be produced if actions are not filed, this will give rise to a "social dilemma."[100] Once derivative actions are dismissed on the grounds that they run contrary to the interests of all shareholders, derivative actions become "incredible" or "empty threat" and lose their effectiveness as a general deterrence.[101]

As such, there is an opinion that the standard for sorting out whether or not the filing of an action is necessary should center on the benefits to society as a whole and not on the interests of shareholders.[102] If we look at the debate in the United States, the Delaware Supreme Court has held that "public policy" should be given consideration as a factor in determining whether or not a derivative action should be allowed to continue.[103] This ruling implicitly found that even though the filing of derivative action imposes a net cost on the company, the deterring of misconducts can bring a net social benefit for society as a whole.[104] In addition, the American Law Institute Corporate Governance: Analysis and

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[100] Iida, 'Shakai-Teki Jirenma to Koukyouzai [Social Dillemma and Public Goods]', above n 99, 62-3.

[101] Charles J. Goetz, 'Verdict on Corporate Liability Rules and the Derivative Suit: Not Proven', *Cornell L. Rev.,* 71 (1986), 344, 347-49.

[102] Takahashi, *Tajū Daihyō Soshō Seido No Arikata : HitsuyōSei to Seido Sekkei [Design of Double Derivative Actions-the Need and System Design-]* , above n 26, 175-82.

[103] See Zapata Corp. v. Maldonado, 430 A.2d 779, 789 (Del.1981).

[104] Kraakman, Park, and Shavell, 'When Are Shareholder Suits in Shareholder Interests', above n 24, 1756.

Recommendations clearly states that the courts should take public interests into consideration in determining whether or not to allow the continuance of an action.[105]

Certainly, if there are benefits to society as a whole, these are realised on the backs of the shareholders at the company where the action is brought, and gives rise to a "transfer of benefits" from the company subject the derivative action to other companies, and the issue becomes the basis for the justification of this "transfer of benefits."[106] In the long term, a company that brings a derivative action will enjoy similar benefits from other companies that bring derivative actions in the future, and this "interchanging of positions" may eliminate the "transfer of benefits."[107] Additionally, since shareholders are able to diversify their investments and enjoy major benefits from the general deterrence of derivative actions, even if a specific investor incurs the costs of filing a derivative action, the benefits from the general deterrence may exceed the costs in terms of

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[105] See American Law Institute, *Principles of Corporate Governance : Analysis and Recommendations, Part Vii. Intro.Note. Reporter's Note 2* (1994), section 7.10 (b).

[106] Kato, 'Guroup Kigyou No Kisei-Houhou Ni Kansuru Ichikosatsu (3) [an Inquiry into Legal Measures for Regulating Corporate Groups (3)]', above n 26, 2209.

[107] Takahashi, *Tajū Daihyō Soshō Seido No Arikata : HitsuyōSei to Seido Sekkei [Design of Double Derivative Actions-the Need and System Design-]* , above n 26, 177. See generally Louis Kaplow and Steven Shavell, *Fairness Versus Welfare* (Harvard University Press, 2002), 100-103.

his/her overall investment portfolio.[108] As such, when emphasising the general deterrence and legal rule production functions of derivative actions, "type 2" strike suits or inappropriate suits should be considered to be "cases where the benefits to society as a whole do not exceed the costs" instead of "cases filed contrary to the interests of shareholders as a whole."[109]

Here, the motives of the plaintiff shareholders are relevant in the context of the abuse or inadequate filing of derivative actions. For example, a plaintiff shareholder may file an action for motives other than economic incentives. At a glance, the filing of such actions may be considered an abuse of derivative actions. However, not all actions filed for non-monetary incentives are improper. There are instances where shareholders bring derivative actions to express anger for misconduct by directors or to punish directors and not for the purpose of monetary gain.[110] There may also be instances where a shareholder who has a dispute with

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[108] Coffee and Schwartz, 'The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform', above n 27, 308; William A. Klein, John C. Coffee, and Frank Partnoy, *Business Organization and Finance : Legal and Economic Principles* (11th edn.: Thomson Reuters/Foundation Press, 2010), 213.

[109] Coffee and Schwartz, 'The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform', above n 27, 308; Klein, Coffee, and Partnoy, *Business Organization and Finance : Legal and Economic Principles* , above n 108, 213; Takahashi, *Tajū Daihyō Soshō Seido No Arikata : HitsuyōSei to Seido Sekkei [Design of Double Derivative Actions-the Need and System Design-]* , above n 26, 175.

[110] Erickson, 'Corporate Misconduct and the Perfect Storm of Shareholder Litigation', above n 24, 120.

a director brings a derivative action when a major scandal occurs at the company in order to exact revenge on the defendant director or to resolve troubles they have with the company. As such, derivative actions filed by plaintiff shareholders for nonmonetary motives may result in recovery and deterrence if the dispute at issue addresses legitimate wrongdoing by the defendant director.[111] As such, it is important to note that a proper derivative action cannot be discerned from an abusive or inadequate action based solely on the motives of the plaintiff shareholders.

1.6. Gatekeepers of Derivative Actions

The next question becomes who is best suited for determining whether or not a derivative action should be continued. There are three major options to answer this question. The first option is to yield to the judgment of the board of directors or a special litigation committee comprised of independent directors. Derivative actions in the United States fall under this option.[112] The second option is to have the courts determine whether or not a derivative action will be permitted to continue. Derivative actions in the United Kingdom fall under this option.[113] The

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[111] Kato, 'Guroup Kigyou No Kisei-Houhou Ni Kansuru Ichikosatsu (3) [an Inquiry into Legal Measures for Regulating Corporate Groups (3)]', , above n 26, 2233.

[112] For detailed discussions in Ch II below under 2.3.

[113] For detailed discussions in Ch II below under 2.2.

third option is to leave the determination up to the individual plaintiff shareholders; i.e. to yield to the judgment of the plaintiff shareholder even if a derivative action is brought by a single shareholder to allow for the continuation of the action without a determination being made by the courts or the board of directors. Derivative actions in Japan fall under this option.[114]

In the consideration of these options, the question that needs to be asked is who is best able to make a determination of whether permitting the derivative action will benefit the interests of shareholders as a whole or benefit society as a whole,[115] or consideration of whose determination will be more effective in demonstrating the functions of derivative actions.

The first option of yielding to the judgment of independent directors is appropriate in making a determination of whether a derivative action is reasonable for the recovery of damages,[116] but becomes contradictory when emphasis is placed on general deterrence and production of legal rules.[117] An independent director is an agent elected by the company's shareholders who is expected to place priority on the interests of all shareholders, and as such he/she is not well suited for taking into consideration the general deterrence or production of legal rules

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[114] See discussions in Ch III below under 3.3.1.

[115] Kato, 'Guroup Kigyou No Kisei-Houhou Ni Kansuru Ichikosatsu (3) [an Inquiry into Legal Measures for Regulating Corporate Groups (3)]', above n 26, 2218-19.

[116] Ibid.

[117] Ibid.

afforded to other companies.[118] In most cases, a determination by the board of directors or a special litigation committee may result in a finding that "bringing an action is not in the interest of the company."[119] Actually, it is said that special litigation committees in the United States almost always dismiss petitions for action.[120] Moreover, those independent directors who formally meet the requirements to be independent directors tend to be friends of management and may not otherwise be truly independent outside directors.[121]

Meanwhile, the second option which yields to the judgment of the courts is well suited for taking into consideration the effects of general deterrence and the production of legal rules. However, this option also has its limitations. It is extremely difficult to quantitatively determine whether the filing of a derivative action will benefit all shareholders or benefit society as a whole. Also, the amount of the actual recovery, the costs imposed on the company, the benefits from specific and general deterrence and the benefit from the production of legal rules

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[118] Coffee and Schwartz, 'The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform', above n 27, 286-87.

[119] Clark, *Corporate Law* , above n 7, 645; Klein, Coffee, and Partnoy, *Business Organization and Finance : Legal and Economic Principles* , above n 108, 212. However, for recent empirical studies, see Myers Minor, 'The Decisions of the Corporate Special Litigation Committees: An Empirical Investigation', *Indiana Law Journal,* 84/4 (2009), 1309-36.

[120] Ibid.

[121] Thompson and Thomas, 'The Public and Private Faces of Derivative Lawsuits', above n 24, 1787.

are not easily quantifiable. As such, a court judgment may not necessarily lead to a detailed individual examination in each and every specific case. It is possible that the accumulated cases may converge in a direction that broadly allows for the filing or continuation of derivative actions based on the court's judgment. Conversely, it is also possible that the establishment of an extremely rigorous judgment standard would lead to equilibrium by barring the filing or continuation of most derivative actions. Either will end up leading the courts to render judgments, on a near automatic basis, based on precedent without making specific judgments for the most part on the merits of the individual cases. This would be commensurate to having no one make individual determinations on whether allowing the filing or continuation of derivative actions would be more beneficial for all shareholders or for society in whole.

Additionally, except in the case of clear strike suits, the third option of yielding to the judgment of the plaintiff shareholder runs the risk that, when allowed, actions will be filed that do not function as recovery or deterrence.[122] Even if the judgment of the plaintiff shareholder is given the highest esteem, there is no guarantee that the plaintiff shareholder will have the proper incentives, information or expertise to determine whether the filing of an action is appropriate in terms of the interests of shareholders as a whole or the interests of society as a whole. Nevertheless, there is one advantage arising from the feature that an

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[122] Kato, 'Guroup Kigyou No Kisei-Houhou Ni Kansuru Ichikosatsu (3) [an Inquiry into Legal Measures for Regulating Corporate Groups (3)]', above n 26, 2218.

action that is filed by a specific shareholder cannot be blocked by the courts or the board of directors. For example, a broad recognition that derivative actions cannot be stopped once filed may work as a “commitment” that heightens the general deterrence of derivative actions. The exposure of directors to the prospect of legal action from “uncontrollable gadflies” will make derivative actions a credible threat, and may prevent the occurrence of a social dilemma.[123] Nevertheless, the nature of the plaintiff shareholder who filed the action also plays a role in determining whether or not this commitment will appropriately function. If most of the filings result in pointless actions, stakeholders will lose trust in the system, defendant directors will simply be viewed as victims and the system may forfeit its general deterrence.[124] On the other hand, a greater number of meaningful actions would like increase the general deterrence.[125]

As addressed above, there are multiple options for addressing the question of who is best suited to determine the appropriateness of derivative actions, and all of these options have their advantages and disadvantages.

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[123] Goetz, 'Verdict on Corporate Liability Rules and the Derivative Suit: Not Proven', above n 101, 348.

[124] Erickson, 'Corporate Governance in the Courtroom: An Empirical Analysis', above n 38, 129; Cox, 'The Social Meaning of Shareholder Suits', above n 24, 6; Kato, 'Guroup Kigyou No Kisei-Houhou Ni Kansuru Ichikosatsu (3) [an Inquiry into Legal Measures for Regulating Corporate Groups (3)]', above n 26, 2211.

[125] Kato, 'Guroup Kigyou No Kisei-Houhou Ni Kansuru Ichikosatsu (3) [an Inquiry into Legal Measures for Regulating Corporate Groups (3)]', above n 26, 2211.

1.7. Difference in Shareholder Derivative Actions between Listed Companies and Closed Companies

When considering abuse of shareholder derivative actions, focus should center on the differences of the relations of shareholders and directors brought about by the differences in capital structure. At listed companies, with the exclusion of controlling shareholders and the like, information is asymmetric between general shareholders and directors. Listed companies have a number of statutory disclosures and a wealth of publicly available information, but there is just so much more internal information which is not externally available to the public than there is public information. Information that is critical in determining breaches of duties by directors is also internal information that is not publicly released. General shareholders are unable to access this internal information. This information asymmetry often causes shareholder derivative actions to end without accountability, for reasons unknown to general shareholders, despite the existence of actual cases where directors are suspected of breaching their duties. Those who seek to become plaintiff shareholders are unable to detect whether any such internal information exists due to information asymmetry, making it difficult to obtain evidence demonstrating a breach of duty by a director, and are likely thus sometimes forced to give up on the filing of a legal action. As such, for those seeking to become plaintiff shareholders, the information asymmetry at listed companies acts as a barrier to the filing of shareholder derivative actions, and

relegates shareholder derivative actions to a state of under enforcement. In other words, the level of shareholder derivative actions end up being kept at a level that is lower than originally intended. In reality, the filing of a shareholder derivative action may end up simply piggy backing on criminal penalties, administrative penalties or other public enforcement.

Meanwhile, the number of shareholders is limited at closed companies. Often shareholders also serve as directors. Sometimes the shareholders and directors have a kinship relation. Compared to listed companies, shareholders are often able to more easily access internal information at closed companies. As such, the information asymmetry between shareholders and directors is not so pronounced at closed companies. The inability to access internal information is less likely to act as a barrier to the filing of shareholder derivative actions.

From a corporate governance perspective, what is important in the capital structure of closed companies is the relative difficulty of agency issues arising between shareholders and directors, and alternatively the ease of conflicts of interest issues arising among shareholders. In particular, if there are controlling shareholders and non-controlling shareholders, conflicts of interests among shareholders becomes an important issue if there are major shareholders who also serve as directors and major shareholders who do not. For example, if a controlling shareholder who is also a director attempts to sacrifice the overall interests of shareholders in pursuant of their own interests, the non-controlling shareholders should consider utilising a shareholder derivative action as a means to

hold the controlling shareholder-cum-director accountable, in expectation of the recovery of damages and the development of a realistic deterrence function. The problem is that the real issue will end up deviating from the points of dispute in the legal procedures if the opposing opinions between the controlling shareholders and non-controlling shareholders are made into a controversy that takes the form of "bringing a shareholder derivative action against a director." As such, in the case of a closed company, while it is more difficult for an information asymmetry to lead to under enforcement, there is a concern that conflicts among shareholders will be brought to court as shareholder derivative actions, and may be exploited in a manner that differs from the original purpose of shareholder derivative actions. In such instances, the motive of the person seeking to become a plaintiff shareholder is not for the purpose of recovering damages incurred by the company. There is also not consideration regarding the suppression of a breach of duty by directors. If the plaintiff shareholder's purpose is to realise personal gain, there is no longer any need for them to represent the overall interests of shareholders and seek accountability from directors. Shareholder derivative actions have the side effects of depriving the defendant directors of time and energy, and lowering the company's reputation. The costs of such actions are slated to borne by all shareholders.

A shareholder derivative action may be said to be unreasonable if the effect thereof does not exceed these costs. Shareholder derivative actions that are triggered by competing interests among shareholders are used as a means for the

plaintiff shareholder to realise personal gain while sacrificing the overall interests of shareholders, and in that sense they are unreasonable. It is important to provide remedies for non-controlling shareholders who have been oppressed by controlling shareholders and have had interests worth legal protection comprised, that are not shareholder derivative actions.

As set forth above, differences in capital structure should have an impact on how shareholder derivative actions are utilised, and the examinations under the empirical research of this thesis will be separately conducted for listed companies and closed companies.

1.8. Conclusion

Derivative actions have a compensation function, a deterrence effect and a legal rule production function, and are also effective in mitigating the agency problem between directors and shareholders. However, the issue of plaintiff shareholder incentives must be addressed in order for these effects to be demonstrated. Additionally, over-incentivising would intensify the agency problem between the interests of the self-selected plaintiff shareholders and shareholders as a whole. In considering how the derivative action system should be designed, a mechanism must be created that encourages the filing of necessary derivative actions and deters the filing of needless derivative actions. The question then becomes what is the standard for determining the appropriateness of derivative actions? In

particular, general deterrence and the production of legal rules are “positive externalities” in nature, so the question then becomes should consideration be given solely to the interests of all shareholders or to the effect on society as a whole? Another question that needs to be addressed is who is best suited to determine the appropriateness of individual derivative actions?

In considering these questions, we must also ask just how much derivative actions are expected to function in the context of corporate governance. Outside derivative actions there are a variety of means for addressing the agency problem between management and shareholders, such as securities litigation and other direct litigation, means for challenging the effectiveness of shareholder resolutions or director resolutions, and systems for protection the rights of minority shareholders. Discipline is not solely available under a corporate law approach but also under soft law such as corporate governance codes and listing rules prescribed by securities exchanges, or through the market forces. Additionally, wrongdoing is also subject to administrative punishment, criminal punishment and other public enforcement, and the functions served by derivative actions may differ according the effectiveness of these other means. This is why the design of derivative action systems may differ from jurisdiction to jurisdiction. Accordingly, in the following chapter I will analyse the state of derivative actions in other countries focusing on the United States where derivative actions are widely utilised and the United Kingdom where derivative actions are a rarity.

Chapter II DERIVATIVE ACTIONS IN THE UK AND THE US

2.1. Introduction

As observed in Chapter I, derivative actions wield a compensatory function, work as a deterrence, produce legal rules, and play a role in the mitigation of the agency problem between shareholders and directors.[126] Incentives for filing actions must be ensured for plaintiff shareholders and their lawyers to facilitate the effective demonstration of these functions.[127] Side effects that accompany the filing of derivative actions may include abusive or unnecessary filings, and derivative actions are plagued by an agency problem between the self-selected plaintiff shareholders and all other shareholders.[128]

This being the case, questions regarding: (i) how much weight the role of derivative actions should be given as a means for addressing the agency problem between shareholders and directors; (ii) what economic incentives should be secured for plaintiff shareholders and their lawyers when importance is assigned to derivative actions; and (iii) how abusive or unnecessary actions can be deterred while ensuring these incentives, require consideration in the design of the

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[126] For detailed discussions on the functions of derivative actions, see Ch I above under 1.3.

[127] For detailed discussions on the incentive problem, see Ch I above under 1.3.3.

[128] For detailed discussions on the litigation agency costs, see Ch I above under 1.3.5.

derivative action system. These factors vary from jurisdiction to jurisdiction and will aid an empirical determination of what functions are actually being performed by derivative actions in each country.

In this Chapter, I will focus my discussion on countries that contrast with Japan - the United Kingdom and the United States. Derivative actions are rare in the United Kingdom which is unique in that they have another means for the effective achievement of corporate governance. Meanwhile, in the United States, society's view of derivative actions has transformed, and means have evolved for the deterrence of abusive or inappropriate derivative actions. A clarification of the features of derivative actions in these two countries should be useful in determining the realities surrounding derivative actions in Japan. Hereunder, I will briefly lay out the features of derivative actions in the United Kingdom then look at how derivative actions have transformed in the United States.

2.2. Derivative Actions in the United Kingdom

2.2.1. Before the Companies Act 2006

In the United Kingdom, derivative actions have gained recognition through case law but have only been available in very limited cases.[129] Foss v. Harbottle

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[129] See generally Reisberg, *Derivative Actions and Corporate Governance* , above n 9, 88-100.

established the requirements for derivative actions to be continued as followed.[130] First, the "proper plaintiff principle" establishes that, in principle, the company is the entity able to pursue an action for compensation when director causes damages to a company for breach of his or her duties.[131] Next, the "majority principle" limits instances where minority shareholders are entitled to file derivative actions, regardless of a majority shareholder's judgement that the pursuit of liability against directors is unnecessary, to exceptional cases of either "fraud on the minority", "ultra vires transactions" or "breaches of special resolution."[132] Cases of "ultra vires transactions" and "breaches of special resolution procedures" are rare.[133] In reality, derivative actions are mainly utilised in cases of "fraud on the minority."[134] "Fraud on the minority" requires that a director or controlling shareholder secure benefits through wrongdoing and that the wrongdoer had control over the company. Consequently, a claim for damages made against a director who has secured an

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[130] Foss v. Harbottle (1843) 2 Hare 461; 67 ER 189.

[131] Law Commission, 'Shareholder Remedies', *Law Commission Consultation Paper,* 142 (1996), para 1.6 (Shareholder Remedies I).

[132] Ibid, para 4.1.

[133] Mathias M. Siems, 'Private Enforcement of Directors' Duties: Derivative Actions as a Global Phenomenon', in Steven Van Uytsel and Mathias Siems Stefan Wrbka (ed.), *Collective Actions: Enhancing Access to Justice and Reconciling Multilayer Interests?* (Cambridge: Cambridge University Press, 2012), 93-116, 109-10.

[134] Takahito Kato, 'Guroup Kigyou No Kisei-Houhou Ni Kansuru Ichikosatsu (2) [an Inquiry into Legal Measures for Regulating Corporate Groups (2)]', *Hougaku Kyoukai Zasshi,* 129/9 (2012/10 2012a), 1907-71, 1932.

improper benefit through a conflict-of-interest transaction is subject to a derivative action, but a breach of a director's duty of care based on business judgment is not.[135] Additionally, the "wrongdoer control" requirement can never be met at a company that does not have a controlling shareholder. The thinking behind the establishment of these strict requirements has been that it is the board of directors or general meeting of shareholders who would resolve issues arising from a director's breach of his/her duty of care.

As addressed above, the United Kingdom has established a derivative action system by case law but this system is only utilised in extremely limited cases. In reality, derivative actions filings are rare and furthermore final decisions permitting derivative actions are extremely rare.[136] Derivative actions have been pursued mostly in cases involving small, closed companies.[137]

2.2.2. Enactment of Derivative Actions into the Companies Act 2006

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[135] Commission, 'Shareholder Remedies', above n 131, para 4.10 and 4.11.

[136] Cheffins and Black, 'Outside Director Liability across Countries', above n 50, 1407; Armour, 'Enforcement Strategies in Uk Corporate Governance: A Roadmap and Empirical Assessment', above n 79; Armour et al., 'Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States', above n 78, 699-700.

[137] Kato, 'Guroup Kigyou No Kisei-Houhou Ni Kansuru Ichikosatsu (2) [an Inquiry into Legal Measures for Regulating Corporate Groups (2)]', above n 134, 1933.

Amid this, the Companies Act enacted in 2006 expressly established the rules for derivative actions, and one purpose for doing this was to eliminate the vagueness of the case law established under Foss v. Harbottle.[138] On the other hand, there is no intention to escort in the expansion of the exploitable scope of derivative actions. The thinking behind this was a desire to prevent undue intervention in day to day company management through the filing of derivative actions.[139]

Under the case law preceding the enactment of Companies Act 2006 instances where derivative actions were available were limited mostly to cases of "fraud on the minority," and the shared recognition was that this needed to be rectified. Accordingly, the Companies Act 2006 clarified the duties owed by directors to companies and subjected all breaches of these duties to derivative actions, and making it possible to pursue liability through derivative actions for breaches of the duty to exercise reasonable care, skill and diligence. This effort to expand the target of derivative actions would potentially have a great influence on corporate practices.[140] Additionally, "wrongdoer control" was eliminated as a

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[138] UK Companies Act 2006, Pt 11 (ss 260-269). See Commission, 'Shareholder Remedies', above n 131, para 1.4.

[139] Ibid, paras 4.6 and 14.10.

[140] Arad Reisberg, 'Shadows of the Past and Back to the Future: Part 11 of the Uk Companies Act 2006 (in)Action', *ECFR,* 6/2 (2009a), 219-43, 221; Arad Reisberg, 'Derivative Claims under the Companies Act 2006: Much Ado About Nothing?', in John Armour and Jennifer Payne (eds.), *Rationality in Company Law: Essays in Honour of Dd Prentice* (Hart Publishing, 2009b), 17, 24-5, 48.

requirement for the filing of derivative actions making it possible to bring derivative actions even in those instances where there are no controlling shareholders.[141]

Accordingly, the applicable scope of derivative actions was expanded under the Companies Act 2006.[142] At the same time, however, the Companies Act 2006 also incorporated a safeguard against abusive derivative actions by shareholders by requiring, like with the case law prior to its enactment, the permission of the court for the continuation of a derivative action.[143] For example, s 261 provides that a member of a company who brings a derivative claim must apply to the court for permission to continue it. This judicial oversight would serve as a gatekeeper to eliminate derivative actions that run contrary to the company's interests.[144]

As such, the Companies Act 2006 expressly set forth the rules of derivative actions in the United Kingdom and broadly expanded the instances

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[141] Reisberg, 'Derivative Claims under the Companies Act 2006: Much Ado About Nothing?'. above n 140, 22-3.

[142] See generally Reisberg, *Derivative Actions and Corporate Governance* , above n 9, 135-142.

[143] Commission, 'Shareholder Remedies', above n 131, para 6.13; Reisberg, 'Shadows of the Past and Back to the Future: Part 11 of the Uk Companies Act 2006 (in)Action', above n 140, 224.

[144] For detailed explanation on procedural requirements and criteria for the grant of leave, see generally Reisberg, *Derivative Actions and Corporate Governance* , above n 9, 143-158.

where derivative actions are available in law. At the same time, the Act established a court permission system to sort out frivolous derivative actions whereby the courts question whether the action is to the intersets of the company and give consideration to the will of non-interested shareholders and the like to reach a judgment on whether or not to allow the action to continue. It should be noted that such focus on the interests of the company and the will of the shareholders may minimise the importance of the nature and function of general deterrence, the creation of legal rules, which are "public goods" when considering whether a derivative action will be allowed, and may result in limiting the cases in which derivative actions will be allowed to continue.

In addition, the United Kingdom has established a rule which states that the losing party must pay the litigation costs and attorneys' fees for both parties.[145] Though it is said that the losing parties' payment of the litigation costs in a derivative action is not a strict requirement,[146] the possibility that a plaintiff will be forced to cover the defendant's litigation costs and attorneys' fees serves as a disincentive.[147] Additionally, the United Kingdom does not allow large contingent fees as found in the United States. The United Kingdom allows for

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[145] CPR, r. 44.5. See generally Cheffins and Black, 'Outside Director Liability across Countries', above n 50, 1406.

[146] Reisberg, 'Shadows of the Past and Back to the Future: Part 11 of the Uk Companies Act 2006 (in)Action', above n 140, 224.

[147] See generally Arad Reisberg, 'Derivative Actions and the Funding Problem: The Way Forward', *The Journal of Business Law,* (2006), 445-67.

"conditional fees" in the sense that "attorneys' fees are tacked on when prevailing in an action but are reduced or exempted when losing an action" but does not allow for "contingent fees" in the sense of "attorneys' fees at 10% of the amount awarded when prevailing."[148] Additionally, the amount of the conditional lawyers' fees added when prevailing is limited to 100% of the hourly fee.[149] Therefore, plaintiffs' attorneys do not have an economic incentive for developing an attorney market for plaintiff shareholders.[150] The disincentive of litigation costs being paid by the losing party and the lack of incentives for plaintiffs are considered to be reasons for the tepid utilisation of derivative actions even after the enactment of the Companies Act 2006.[151]

2.2.3. The Role of the Court as a Gatekeeper

The situation in the UK is as summarised above. Below, I would like to focus in

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[148] Kato, 'Guroup Kigyou No Kisei-Houhou Ni Kansuru Ichikosatsu (2) [an Inquiry into Legal Measures for Regulating Corporate Groups (2)]', above n 134, 1936.

[149] Ibid.

[150] Cheffins and Black, 'Outside Director Liability across Countries', above n 50, 1405-06.

[151] Ibid, 1408; Armour, 'Enforcement Strategies in Uk Corporate Governance: A Roadmap and Empirical Assessment', above n 79, 115; Reisberg, 'Derivative Claims under the Companies Act 2006: Much Ado About Nothing?'., above n 140, 47-55; Kato, 'Guroup Kigyou No Kisei-Houhou Ni Kansuru Ichikosatsu (2) [an Inquiry into Legal Measures for Regulating Corporate Groups (2)]', above n 134, 1936.

particular on screening for allowing or disallowing derivative actions in the UK in order to gain perspective through comparison with Japanese laws.

As already stated, under the Companies Act 2006 (CA2006), after filing a derivative action with the court, the plaintiff shareholder must obtain the court's permission for the continuation of the action.[152] The purport of this system is to have the court play a role as gatekeeper.[153] Derivative actions function to allow companies to recover damages which they have suffered and to deter directors from engaging in illegal behavior and the like. On the other hand, there is a risk of an agency problem developing between self-selected plaintiff shareholders and other shareholders. Typically, a plaintiff shareholder who is seeking for their individual interests presents a risk of depriving the defendant directors of their energy, damaging the company's reputation, thus harming the overall interests of shareholders. As such, derivative actions have advantages and drawbacks, and screening is required to permit actions which possess significance, but not permit actions that will run contrary to the overall interests of shareholders. The issue becomes who will make such a determination and how will the determination be made, whereby under CA2006 it is the courts which are expected to serve as gatekeepers.

The issue is how the court will make its determination on whether to permit the continuation of a derivative action. On this point, CA2006 provides a two-step

[152] CA2006, s 261(1).

[153] Paul L. Davies and Sarah Worthington, Gower's Principles of Modern Company Law (Eleventh edn., 2021), 576.

mechanism: The first step calls for the plaintiff shareholder to submit initial evidence, and the second step calls for the court to make its determination on whether or not to permit the continuation of the derivative action. The specific content of these respective steps is as follows.

Under the first step, the plaintiff shareholder must submit evidence to support prima facie showing of the content of the claim.[154] If the evidence presented by the plaintiff is insufficient in making a prima facie case for granting permission, the court should not permit the continuation of the derivative action brought by the plaintiff shareholder, and should dismiss the action.

Only the plaintiff shareholder submits evidence at this initial stage. The company is not yet involved in the action, is not required to submit evidence to dispute the plaintiff shareholder's application for permission, and is not required to be a party to hearings. The company only becomes involved, and is to submit evidence, in those procedures surrounding permission for the continuation of the action which will occur after the plaintiff shareholder has succeeded in presenting a prima facie case at the initial stage.[155] As such, it has been pointed out that in this initial stage, there is only a low hurdle to be crossed in order for the plaintiff shareholder to succeed in presenting such a prima facia case since only the plaintiff shareholder submits evidence, with the court making its determination based solely on the content thereof, whereby actions

[154] CA2006, s 261(3).

[155] CA2006. s 261(2).

easily advance to the second stage.[156]

The second step advances the procedures for the court's determination as to whether or not to permit the continuation of the derivative action. These procedures are divided into two parts. Initially a determination is made regarding a mandatory refusal of permission, and next the court makes a discretionary determination as to whether or not it will permit the continuation of the derivative action.

First, with regard to mandatory refusal, CA2006 Section 263(2) prescribes, "Permission (or leave) must be refused if the court is satisfied—(a) that a person acting in accordance with section 172 (duty to promote the success of the company) would not seek to continue the claim, or (b) where the cause of action arises from an act or omission that is yet to occur, that the act or omission has been authorised by the company, or (c) where the cause of action arises from an act or omission that has already occurred, that the act or omission— (i) was authorised by the company before it occurred, or (ii) has been ratified by the company since it occurred."

The foregoing can be broadly classified into two categories: First, the question is whether the act or omission subject to the action was authorised or ratified by the company, and next, whether or not the continuation of the action can be considered to be reasonable from a viewpoint of promoting the success of the company. With regard to the authorisation and ratification of the first question, the fundamental

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[156] Keay, Andrew, and Joan Loughrey. "Something Old, Something New, Something Borrowed: An Analysis of the New Derivative Action Under the Companies Act 2006." *Law quarterly review* 124 (2008): 469–500.

thinking which is presented focuses on the intent of the shareholder. If the act etc. by the director was authorised by a general meeting of shareholders, there is no need to allow minority shareholders who have a differing opinion to have the right to pursue liability for the corresponding act etc. by the director. This CA2006 stipulation that the court must not permit the continuation of an action in instances authorised by the company will not likely give rise to particular controversy.

What is more important is the latter requirement: The court must not permit the continuation of a derivative action in the event "a person acting in accordance with section 172 (to promote the success of the company for the benefit of its members) would not seek to continue the claim."

Section 172 prescribes, "A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole." Factors for consideration of whether a director has fulfilled this duty are enumerated as, "(a) the likely consequences of any decision in the long term, (b) the interests of the company's employees, (c) the need to foster the company's business relationships with suppliers, customers and others, (d) the impact of the company's operations on the community and the environment,(e) the desirability of the company maintaining a reputation for high standards of business conduct, and (f) the need to act fairly as between members of the company." This provision can be said to stipulate the fundamental principles for a director's execution of their duties on behalf of the interests of the company. With regard to whether or not to permit the continuation of a derivative action, ultimately the evaluation criteria

should also be whether it contributes to the overall interests of shareholders. This requirement is significant in the determination on this point.

At the mandatory refusal stage conducted by the court, a “no-director” test has been adopted with regard to the application of this requirement[157]. Namely, the requirement is that no one would continue the derivative action if a director has acted in accordance with Section 172.[158] In instances where opinions vary as to whether a derivative action will be continued among directors who have acted in accordance with Section 172, refusal is not obligatory, and instead, an examination is to be made at the stage of the discretionary determination by the court.[159]

As set forth above, mandatory refusal is made in those instances where there has been authorisation or ratification by the shareholders, and everyone who considers the shareholders’ interests would be in opposition to the continuation of the derivative action. It can thus be said that a negative test has been prescribed on the standard “will it fail to promote the success of the company?”[160]

If the plaintiff shareholder clears this negative test, the court will then make a discretionary determination as to whether it should permit the continuation of the

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157 Davies and Worthington, Gower's Principles of Modern Company Law , above n 153, 580.

158 Iesini v Westrip Holdings Ltd [2010] B.C.C. 420 at [84]–[86]; Kiani v Cooper [2010] EWHC 577 (Ch); [2010] B.C.C. 463 at [13]–[14]; Stainer v Lee [2011] B.C.C. 134 at [27]–[28].

159 Ibid.

160 Davies and Worthington, Gower's Principles of Modern Company Law , above n 153, 580.

derivative action. With regard to this determination, CA2006 Section 262(3) lists and enumerates the circumstances that should be taken into consideration by the court in making its determination as to whether or not to grant permission. The six enumerated factors are:

(a) whether the member is acting in good faith in seeking to continue the claim;

(b) the importance that a person acting in accordance with section 172 (duty to promote the success of the company) would attach to continuing it;

(c) where the cause of action results from an act or omission that is yet to occur, whether the act or omission could be, and in the circumstances would be likely to be—(i) authorised by the company before it occurs, or (ii)ratified by the company after it occurs;

(d) where the cause of action arises from an act or omission that has already occurred, whether the act or omission could be, and in the circumstances would be likely to be, ratified by the company;

(e) whether the company has decided not to pursue the claim; and,

(f) whether the act or omission in respect of which the claim is brought gives rise to a cause of action that the member could pursue in his own right rather than on behalf of the company.

In addition thereto, CA2006 Section 262(4) prescribes, "In considering whether to give permission (or leave) the court shall have particular regard to any evidence before it as to the views of members of the company who have no personal

interest, direct or indirect, in the matter."

As set forth above, seven items are presented as example factors that should be taken into consideration by the court. The court is to make its determination as to whether or not it should permit the continuation of a derivative action while taking into consideration these seven factors as well as other circumstances. In comparison to the negative test for mandatory refusal, this determination may be called a positive test which conducts examination from the perspective of "will the litigation promote the success of the company?"[161] These seven items are considered to deftly extract the key factors for making a determination as to whether the continuation of the derivative action will contribute to the overall interests of the shareholders.

First, by considering the factor "(a) whether the member is acting in good faith in seeking to continue the claim," it is possible to disallow continuation and to secure the overall interests of shareholders in a case where, for example, the plaintiff shareholder is bringing a derivative action seeking private interests. A side effect of a derivative action can be an agency problem between the self-selected plaintiff shareholders and other shareholders, and the consideration factor expressed in the foregoing (a) is significant in addressing this issue.

Secondly, "(b) the importance that a person acting in accordance with section 172 (duty to promote the success of the company) would attach to continuing it" determines whether that derivative shareholder action contributes to the interests of the company, and can be said to be a particularly important factor among these seven

[161] Ibid.

factors. The issue with regard to this consideration factor is how the court will specifically make the determination. The question of whether it will be easy or difficult to permit the continuation of a derivative action will be greatly impacted by how the court considers these factors.

First, if the director acted in accordance with Section 172, in its determination regarding whether or not to continue the derivative action, it has been construed that the court should take into consideration a wide variety of circumstances including: "the size of the claim; the strength of the claim; the cost of the proceedings; the company's ability to fund the proceedings; the ability of the potential defendants to satisfy a judgment; the impact on the company if it lost the claim and had to pay not only its own costs but the defendant's as well; any disruption to the company's activities while the claim is pursued; whether the prosecution of the claim would damage the company in other ways (e.g. by losing the services of a valuable employee or alienating a key supplier or customer) and so on …"[162]

Nevertheless, to take into account such a wide variety of circumstances is not a simple task. If, for example, the court's determination of whether or not the derivative action contributes to the company's interests is a "commercial decision"[163], the court is thought to lack the ability to make the determination, and if emphasis is placed on the negative effects incidental to the continuation of the derivative action, in most cases, proceedings would then be halted at the entry stage of whether or not a

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[162] Iesini v Westrip Holdings Ltd [2010] B.C.C. 420 at [85]

[163] Ibid.

derivative action should be permitted, and the utilisation of derivative actions would not progress.

For certain, a determination of whether or not a derivative action contributes to the interests of a company is a commercial decision, and is a difficult determination. The continuation of a derivative action will certainly give rise to such negative effects as having a chilling effect on directors, incurring costs for addressing the action, damaging the company's reputation, and divulging information. If this point is emphasised, it will likely increase the height of the hurdle for obtaining permission for the continuation of the derivative action with regard to the factor expressed in (b) above.

As empirical findings on this point, a search was conducted using the Lexis database for the period from October 2007, when CA2006 was enacted, through December 2017, and found (i) 33 derivative actions had been filed, (ii) of these, only two were derivative actions at listed companies, and (iii) continuation of the action was permitted in 10 of the 33 actions, less than one-third[164]. Evaluations of these numbers have indicated that utilisation of derivative actions has not greatly been advanced since the enactment of CA2006, and utilisation is lower than in other jurisdictions.[165]

What deserves to be noted here is that, with regard to the effect from the continuation of a derivative action, giving consideration only to the effect on the

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[164] John Armour, "Derivative Actions: A Framework for Decisions" (2019) 135 Law Quarterly Review 412, 427-428.

[165] Ibid.

company or the defendant directors is problematic in that it fails to take into account the general deterrence effect, the legal rule creation function and other effects brought about by derivative actions. The general deterrence effect and legal rule creation function each produce benefits for other companies above and beyond just the company bringing the derivative action. In economic terms, it has “positive externality.” Consideration is not given to this externality under a perspective that looks only at whether or not the continuation of the derivative action will contribute to the overall interests of the subject company’s shareholders. The question of whether or not such a determination is acceptable requires an examination of what functions are to be expected of derivative actions, and under other systems.

Thirdly, “(c) where the cause of action results from an act or omission that is yet to occur, whether the act or omission could be, and in the circumstances would be likely to be—(i) authorised by the company before it occurs, or (ii) ratified by the company after it occurs” is a consideration factor for respecting the judgment of the company, i.e. the shareholders. The same likewise applies to the fourth factor “where the cause of action arises from an act or omission that has already occurred, whether the act or omission could be, and in the circumstances would be likely to be, ratified by the company.”

If the “shareholder authorisation or ratification” which is the focus of these factors has already been made, it falls under the court’s negative test of mandatory refusal, and the continuation of the derivative action will not be permitted. Beyond this stage, arriving at the stage of a discretionary determination by the court means that

shareholder authorisation or ratification was not made in actuality. There, when making a discretionary determination of whether or not to permit the continuation of the derivative action, the court will consider whether it “could be, and in the circumstances would be likely to be” ratified by the company. Under common law, the question of whether or not there is a prospect for obtaining shareholder authorisation or ratification is extremely significant, and if it is possible in theory, the derivative action is not allowed.[166] Meanwhile, under CA2006, the prospect for obtaining shareholder authorisation or ratification is only a single consideration factor.

Fifthly, the consideration factor of “(e) whether the company has decided not to pursue the claim” is also a factor for respecting the intent of the company, i.e. the shareholders. Here, the decision by the company may be a decision by the board of directors or a decision by the general meeting of shareholders.[167] However, in instances where the defendant directors account of a majority of the board of directors, the court should not attach importance to such circumstances even if the board of directors has decided not to pursue the claim.[168]

Sixthly, the factor “(f) whether the act or omission in respect of which the claim is brought gives rise to a cause of action that the member could pursue in his own right rather than on behalf of the company” takes into account the need for the continuation of a derivative action to the extent of having all shareholders bear the

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[166] Foss v Harbottle (1843) 2 Hare 461,Edwards v Halliwell [1950] 2 All E.R. 1064.

[167] Davies and Worthington, Gower's Principles of Modern Company Law, above n 153, 580.

[168] Cullen Investments v Brown [2015] EWHC 472 (Ch)

costs in circumstances in which the plaintiff shareholder can get relief by an alternative means.[169] Typically, this assumes instances were a shareholder seeks relief for unfair prejudicial conduct by a controlling shareholder.[170]

Finally, CA2006 Section 262(4) prescribes, "In considering whether to give permission (or leave) the court shall have particular regard to any evidence before it as to the views of members of the company who have no personal interest, direct or indirect, in the matter." This provision stresses emphasis on the opinions of non-interested shareholders, and while this is only a single factor, it is much more likely that the court will not grant permission if it is clarified through evidence that independent shareholders are opposed to the continuation of the derivative action.[171]

A summary of the foregoing is as follows:

(i) In the UK, the courts have been entrusted with the role of gatekeeper over the question of whether or not the continuation of a derivative action will be allowed.

(ii) This screening is conducted in two stages: In the first stage, an initial check is conducted as to whether the plaintiff shareholder has submitted evidence sufficient to present a prima facie case for a breach of duty by the defendant director(s) identified in the derivative

[169] Gill v Thind [2020] EWHC 2973 (Ch) at [88].

[170] CA 2006, s.994(1). See also Franbar Holdings Ltd v Patel [2008] EWHC 1534 (Ch); [2009] 1 B.C.L.C. 1.

[171] Davies and Worthington, Gower's Principles of Modern Company Law , above n 153, 584.

action, i.e. whether or not the plaintiff is able to submit the minimally required evidence.

(iii) Once transitioned to the second stage, initially a negative test is conducted, and if the subject act or omission has been authorised or ratified by shareholders, or if none of the directors who are considering the interests of the company pursue the derivative action, the court will refuse continuation.

(iv) Next, a determination is made through a positive test applied by the court as to whether the derivative action contributes to the interests of the company. In this determination, consideration is given regarding conflict of interest issues among shareholders, but taking into account whether the plaintiff shareholder is pursuing personal interests, and what other shareholders think. What is most important is a comprehensive determination regarding whether or not the derivative action contributes to the overall interests of shareholders. In this determination, if emphasis is placed upon the various costs incurred by the company through the derivative action, it becomes more difficult to grant permission for the derivative action to proceed. Actually, it seems that under present conditions the courts are not readily issuing permissions.

2.2.4. Unfair Prejudice Actions

What should be noted here, however, is that shareholders in the United Kingdom are able to utilise the unfair prejudice remedy as well as derivative actions. The courts have upheld unfair prejudice actions even in cases where derivative actions were available up.[172] Under unfair prejudice actions the courts have more flexibility in the remedies available to plaintiff shareholders, and in practice the courts have ordered monetary payments to plaintiff shareholders or obligated the buyout of the plaintiff shareholders' shares.[173] The flexible remedies available to shareholders as unfair prejudice remedies have reduced the need for derivative actions with their high procedural hurdles, and in practice, unfair prejudice have become an "all-purpose instrument" in privately held firms.[174]

2.2.5. Summary

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[172] Davies and Worthington, Gower's Principles of Modern Company Law , above n 153, 550-555.

[173] Companies Act, s. 996(2). See Martin Gelter, 'Mapping Types of Shareholder Lawsuits across Jurisdictions', in Sean Griffith et al. (eds.), *Research Handbook on Representative Shareholder Litigation* (Edward Elgar Publishing Limited, 2018), 470.

[174] Armour et al., 'Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States', above n 78, 695-6; Cheffins and Black, 'Outside Director Liability across Countries', above n 50, 1409-10; Gelter, 'Mapping Types of Shareholder Lawsuits across Jurisdictions'., above n 153, 470.

As demonstrated above, though a derivative action system exists in the United Kingdom under case law and statutory law, in practice these actions are filed in only limited cases due to the disincentive to the plaintiff arising from the loosing parties' payment of litigation costs and the existence of a fee system which does not give rise to economic incentives for attorneys. Shareholders are able to utilise unfair prejudice actions as alternative remedies, and in the United Kingdom the development of shareholder monitoring through informal dialogue and engagement with management has played a key role in corporate governance, particularly in the case of institutional investors. Public enforcement by the U.K. Takeover Panel plays a key role in takeovers and has usurped private enforcement through derivative actions.[175] These circumstances have come together to make it so that derivative actions are not the "norm" in the United Kingdom.[176] Given that derivative actions are considered to be accompanied by perverse incentives, there is no need to promote derivative actions as long as another means is developed to address the agency problem between shareholders and management. The fact that investors in the United Kingdom have trust in the stock market even though derivative actions are not utilised for the most part is one evidence that derivative actions are nothing more than one option for corporate governance.

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[175] Armour et al., 'Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States', above n 78.

[176] Iris Chiu, 'Reviving Shareholder Stewardship: Critically Examining the Impact of Corporate Transparency Reforms in the Uk', *Delaware Journal of Corporate Law,* 38/3 (2014), 983-1023, 995.

2.3. Derivative Actions in the United States

2.3.1. Filing of a Large Number of Derivative Actions - Through the Mid-1970s

The assessment of derivative actions has evolved in the United States. Years ago, derivative actions were considered the core means for disciplining directors. In the symbolic Cohen case, in 1949 the Supreme Court described derivative actions as the "chief regulator of corporate management."[177] A large number of derivative actions were filed in the 1950s and the 1960s, and these actions were said to have played a key role in effecting corporate governance.[178] Plaintiff shareholders were even referred to as the "private lawyer general."[179]

However, at the same time there was also a view that the filing of derivative actions should be controlled, and the Wood Report published in 1944

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[177] Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 548 (1949). See also e.g., Brendle v. Smith, 46 F.Supp. 522, 525-26 (S.D.N.Y. 1942).

[178] Coffee and Schwartz, 'The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform', , above n 27, 262; Daniel J. Dykstra, 'The Revival of the Derivative Suit', *University of Pennsylvania Law Review,* 116/1 (1967), 74-101.

[179] Coffee, 'Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working', , above n 64, 216.

provided empirical support for a negative assessment of derivative actions.[180] This report was the first intensive study to look at the realities of derivative actions in the United States.[181] The author, Franklin Wood, was hired by the Chamber of Commerce of the State of New York to study the derivative actions filed in New York state courts and federal courts between 1932 and 1942. In his report Mr. Wood found that derivative actions were not effectively functioning under the realities of the time. The Wood Report found that of the 573 derivative actions brought public companies, only 46 ended in compensation being provided by the defendant directors, and that compensation was limited to less than 3% of the amount sought by the plaintiff shareholders in many of the cases ending in settlement. Based on this trend, the report identified "[t]he outstanding fact derived from this survey is the large preponderance of unsuccessful and unfounded stockholder derivative actions." In other words, the majority of the derivative actions filed at that time lacked a sufficient basis and ended in failure. The Wood Report also introduced the existence of derivative actions filed by shareholders who only hold a nominal number of shares. Based on anecdotal evidence, the Wood Report identified "[t]his shoddy burlesque of a professional relationship to clients makes the ambulance-chaser by comparison a paragon of propriety." Even

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[180] Franklin S. Wood, *Survey and Report Regarding Stockholders' Derivative Suits* (1944).

[181] Jessica Erickson, 'The (Un)Changing Derivative Suit', in Sean Griffith et al. (eds.), *Research Handbook on Representative Shareholder Litigation* (Edward Elgar Publishing, 2018), 58-79.

more remarkable is the insinuation of lawyer-driven derivative actions and no small extent of strike suites. The Wood Report was influential in fostering a critical view of derivative actions. In the 1940s, in an attempt to control derivative actions, New York introduced legislation mandating the provision of security by plaintiff shareholders to cover the defendants' costs.[182] Nevertheless, in practice the system for the issuance of orders for the provision of security was ineffective,[183] and as addressed above, a large number of derivative actions persisted into the 1960s and this trend continued into the late1970s.

2.3.2. Incentives for Plaintiff Shareholders and Their Lawyers

Why, then, were derivative actions actively utilised in the United States through the late 1970s? Were they unaware of the lack of incentives? The key to understanding this, as will be addressed below, were the economic incentives for the plaintiffs' lawyers and not incentives for the plaintiff shareholders.[184]

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[182] See generally G. Hornstein, 'The Death Knell of Stockholders' Derivative Suits in New York', *California Law Review,* 32 (1944), 123-45.

[183] Coffee and Schwartz, 'The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform', above n 27, 261; Clark, *Corporate Law* , above n 7, 652-55; William T. Allen, Reinier H. Kraakman, and Guhan Subramanian, *Commentaries and Cases on the Law of Business Organization* (4th edn., Aspen Casebook Series: Wolters Kluwer Law & Business, 2012), 376.

[184] Wood, *Survey and Report Regarding Stockholders' Derivative Suits* , above n

First, with regard to the question of the ease of filing actions by plaintiff shareholders, i.e. the lack of disincentives for filing actions, there was no minimum ownership requirement where plaintiff shareholders were required to hold shares when filing an action.[185] Under such circumstances, no major procedural obstacle to the filing of actions appeared until the 1970s. Additionally, the principle in the United States is that regardless of the outcome of the action the plaintiff and the defendant must each bear their own lawyers' fees.[186] This means that even if a plaintiff shareholder is unsuccessful in a derivative action, he/she is not on the line

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180; John E. Kennedy, 'Securities Class and Derivative Actions in the United States District Court for the Northern District of Texas: An Empirical Study', *Houston Law Review,* 14 (1977), 769-811; Thomas Jones, 'An Empirical Examination of the Incidence of Shareholder Derivative and Class Action Lawsuits, 1971-1978', *Boston University Law Review,* 60 (1980b), 306-30; Thomas Jones, 'An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits', *Boston University Law Review,* 60 (1980a), 542-73; Coffee and Schwartz, 'The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform', above n 27; Fischel and Bradley, 'The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis', ; Romano, 'The Shareholder Suit: Litigation without Foundation?', ; Erickson, 'Corporate Governance in the Courtroom: An Empirical Analysis', .

[185] See generally Gelter, 'Why Do Shareholder Derivative Suits Remain Rare in Continental Europe?', above n 21, 856-861.

[186] Coffee, 'The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation', , above n 49,15-6; Reisberg, *Derivative Actions and Corporate Governance* , above n 9, 226-28.

for the defendant's lawyers' fees. Would-be plaintiff shareholders are more hesitant to file actions under a system that burdens the losing party with lawyers' fees and the other costs of litigation. The non-existence of a system in the United States which placed the burden of court costs on the losing party eliminated disincentives for the plaintiff shareholders.[187]

Nevertheless, a system that makes it easy to file actions and burdens the parties with their own court costs will not necessarily give rise to incentives for the aggressive utilisation of derivative actions. Even though derivative actions were widely filed in the United States, no measures were put in place to overcome the plaintiff shareholder incentive issue. Instead, the lawyers for the plaintiff shareholders were the stakeholders who held the economic incentives for bringing derivative actions.[188] Plaintiffs' lawyers are considered to be the driving force behind derivative actions,[189] due mainly to the wide acceptance of a contingent fee billing system and the company's payment of lawyers' fees if a plaintiff shareholder prevails.[190] Under a contingent fee billing system, the plaintiff

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[187] Ibid.

[188] See Ch I above under 1.3.5.

[189] Coffee and Schwartz, 'The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform', above n 27, 316; Klein, Coffee, and Partnoy, *Business Organization and Finance : Legal and Economic Principles* , above n 108, 208.

[190] Coffee and Schwartz, 'The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform', above n 27, 316; Gelter, 'Why Do Shareholder

shareholder is not required to bear the heavy burden of lawyers' fees in the filing of an action, and if they prevail the company pays the high-priced contingent fee. The contingent fee system frees the plaintiff shareholder from most costs of litigation by placing the burden for the lawyer's contingent fee on the company.[191] As such, plaintiffs' lawyers have economic incentives for searching for potential plaintiffs and file derivative actions in expectedly high-value cases. Additionally, in the United States a lawyer's contingent fee is paid even when a derivative action ends in a settlement.[192] Also, the method of how the contingent fee is calculated also serves as a factor. The contingent fees are calculated based on not only the amount of defendant directors' obligation to pay damages to the company, they also factors including the new election of independent directors and the reform of corporate governance through derivative actions.[193] These factors stack up to provide plaintiffs' lawyers with strong economic incentives for bringing derivative

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Derivative Suits Remain Rare in Continental Europe?', above n 21; Kraakman et al., *The Anatomy of Corporate Law*, above n 1, 164-65.

[191] See generally Romano, 'The Shareholder Suit: Litigation without Foundation?', above n 30.

[192] For suggestions that it is generally difficult for the court to interfere with contents of settlements, see Coffee and Schwartz, 'The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform', above n 27, 318-19; Cox, 'The Social Meaning of Shareholder Suits', , above n 24, 33-5.

[193] Romano, 'The Shareholder Suit: Litigation without Foundation?', above n 30; Erickson, 'Corporate Governance in the Courtroom: An Empirical Analysis', above n 38.

actions.[194] As a result, the plaintiff's lawyers and not the shareholder plaintiffs have been the main player of derivative actions in the United States.[195] In particular, lawyers on the plaintiff shareholders' side of derivative actions tend to bring a number of actions even in those instances where there is little prospect for success on the assumption that they will recover a large sum of fees in a portion of the actions.[196] Even if only a few number of cases end in a favorable ruling or settlement, the filing of a large number of actions may be determined to be economically feasible due to the large amount of fees recoverable in the successful cases.[197] Accordingly, the economic incentives for plaintiff shareholders' lawyers cause them to behave as "risk-taking entrepreneurs."[198] The persistence of

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[194] Kraakman, Park, and Shavell, 'When Are Shareholder Suits in Shareholder Interests', , above n 24, 1743; Erickson, 'Corporate Misconduct and the Perfect Storm of Shareholder Litigation', , above n 24, 101.

[195] Coffee and Schwartz, 'The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform', above n 27, 316; Klein, Coffee, and Partnoy, *Business Organization and Finance : Legal and Economic Principles* , above n 108, 208.

[196] Franklin A. Gevurtz, 'Who Represents the Corporation - in Search of a Better Method for Determining the Corporate Interest in Derivative Suits', *U. Pitt. L. Rev.,* 46 (1985), 265, 291; Cox, 'The Social Meaning of Shareholder Suits', above n 24, 32; Erickson, 'Corporate Misconduct and the Perfect Storm of Shareholder Litigation', above n 24, 101; Thomas and Thompson, 'Empirical Studies of Representative Litigation'., above n 28, 155.

[197] Takahashi, *Tajū Daihyō Soshō Seido No Arikata : HitsuyōSei to Seido Sekkei [Design of Double Derivative Actions-the Need and System Design-]* , above n 26, 132.

[198] Coffee, 'Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law through Class and Derivative Actions', , above n 58, 676.

lawyer-driven derivative actions has caused lawyers to be perceived more as "bounty hunters" than as "private attorney general."[199]

2.3.3. Criticism of Side Effects from Lawyer-Driven Derivative Actions

The economic incentive from these high-value fees is not in itself inappropriate. Lawyers' incentives ensure a real prospect for the filing of derivative actions,[200] and result in the wielding of a general deterrence by derivative actions.[201] The accumulation of precedent is also useful in illuminating legal rules regarding the explicit director duties and responsibilities.[202]

However, the negative effects are also noteworthy. In particular, the abusive or inappropriate filing of derivative actions by plaintiffs' lawyers has

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[199] Coffee, 'Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working', above n 64, 217-28; Coffee, 'Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law through Class and Derivative Actions', above n 58, 679; Takahashi, *Tajū Daihyō Soshō Seido No Arikata : HitsuyōSei to Seido Sekkei [Design of Double Derivative Actions-the Need and System Design-]* , above n 26, 132.

[200] Allen, Kraakman, and Subramanian, *Commentaries and Cases on the Law of Business Organization* , above n 183, 370-71; Romano, 'The Shareholder Suit: Litigation without Foundation?', above n 30, 55.

[201] For detailed discussions on the function of deterrence, see Ch I above under 1.3.2.

[202] For detailed discussions on the function of the creation of legal rules, see Ch I above under 1.3.7.

become increasingly prominent. Particularly troubling are settlements that run contrary to the interests of shareholders as a whole which are reached by collusion between the plaintiffs' lawyers and the defendants' lawyers.[203] What comes to mind, for example, are cases where there is a high likeliness that the plaintiff's claims will be dismissed. In such instances, even if it is unlikely they will lose, defendants' lawyers may push for settlements because they do not really want to be troubled by a response to the action or may accept a settlement because they fear harm in terms of reputation.[204] There may also be instances where defendants' lawyers may mentally focus too much on the possibility of losing, no matter how small, and select settlements rather than a final conclusion.[205] Additionally, even though the defendant is forced to bear the plaintiff lawyers' fees in a settlement, the defendant director has an incentive to conclude the suit by settlement without worrying about the costs since the plaintiff's side lawyers' fees will be covered by D&O insurance or indemnified by the company.[206] Under such circumstances, it

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[203] Takahashi, *Tajū Daihyō Soshō Seido No Arikata : HitsuyōSei to Seido Sekkei [Design of Double Derivative Actions-the Need and System Design-]* , above n 26, 132.

[204] Allen, Kraakman, and Subramanian, *Commentaries and Cases on the Law of Business Organization* , above n 183, 375.

[205] See generally Chris Guthrie, 'Framing Frivolous Litigation: A Psychological Theory', *The University of Chicago Law Review,* 67/1 (2000), 163.

[206] Romano, 'The Shareholder Suit: Litigation without Foundation?', above n 30, 57; Allen, Kraakman, and Subramanian, *Commentaries and Cases on the Law of Business Organization* , above n 183, 375.

is possible that a considerable number of cases are resolved by settlement even if there is a high probability that the claims would be dismissed.

At the same time, the possibility of settlement exists even in those cases where it likely the plaintiff's claims will be upheld.[207] Plaintiffs' lawyers tend to attach importance to a sure win by settlement, and defendants' lawyers have an incentive to accept a settlement if it mitigates liability even to a marginal extent. This shared consciousness gives rise to the possibility of collusion between plaintiff's lawyers and defendants' lawyers. In a typical inappropriate settlement, the defendant director will escape liability for a large amount of damages by paying the company a small sum of damages or gesturing a commitment to reform corporate governance, and in exchange therefor the company pays large-sum fees to the plaintiff's lawyers.[208]

Though the courts are required to approval settlements, they are unlikely to make any substantial review and tend not to preclude settlements by collusion.[209]

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[207] Klein, Coffee, and Partnoy, *Business Organization and Finance : Legal and Economic Principles* , above n 108, 208.

[208] Ibid.

[209] Romano, 'The Shareholder Suit: Litigation without Foundation?', above n 30, 57; Erickson, 'Corporate Governance in the Courtroom: An Empirical Analysis', above n 38, 1824-25; Coffee, 'Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working', above n 64, 237; Coffee and Schwartz, 'The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform', above n 27, 318-19; Cox, 'The Social Meaning of Shareholder Suits', above n 24, 33-5.

Plaintiff shareholders do not attempt to block in appropriate settlements reached by the lawyers since there is no real effect on their economic interests.[210] As a result, there are some plaintiffs' lawyers who file multiple derivative actions, including actions that have a low prospect of prevailing, in an attempt to earn large fees through a settlement by collusion.[211] Due to the increase in these abusive or inappropriate filings, awareness of the need of safety mechanisms to control the filing of derivative actions swelled in the 1970s and 1980s.

2.3.4 Development of Safeguard Mechanisms

The demand requirement and special litigation committees have played a particularly key role in controlling abusive derivative actions. In the United States, in principle the pre-suit demand requirement must be satisfied in order for a plaintiff shareholder to bring a derivative action, and the claim filing procedures may be summarised as follows. When seeking to bring a derivative action, the

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[210] Jonathan R. Macey and Geoffrey P. Miller, 'The Plaintiffs Attorneys Role in Class-Action and Derivative Litigation - Economic-Analysis and Recommendations for Reform', *University Of Chicago Law Review,* 58/1 (1991b), 1-118; Erickson, 'Corporate Misconduct and the Perfect Storm of Shareholder Litigation', above n 24, 101; Jessica Erickson, 'The Gatekeepers of Shareholder Litigation', *Oklahoma Law Review,* 70/1 (2017), 237, 238.

[211] Klein, Coffee, and Partnoy, *Business Organization and Finance : Legal and Economic Principles* , above n 108, 209.

shareholder must make a demand to the board of directors to have the company become the plaintiff and bring suit against a director.[212] The shareholder is not entitled to bring a derivative action if the board of directors brings suit against the director in response to this demand,[213] but may bring a derivative action if the board of directors refused to bring suit.[214]

The court then determines whether or not the derivative actions should be allowed to go forward. In making this determination, the court looks at whether the board of directors' refusal of the demand for action was reasonable, and the lawsuit is allowed to go forward if it determines that the board of directors' refusal was unreasonable. The derivative action is dismissed if the court upholds and finds the board of directors' determination to be reasonable. One exemption to this fundamental rule is that a plaintiff can bypass that requirement if he/she can show that the demand would have been futile, and in such instances a shareholder is allowed to bring a derivative action without making the pre-suit demand.[215]

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[212] Federal Rule 23.1. See generally Stephen M. Bainbridge, *Corporate Law* (Third edn.: Foundation Press, 2015), 225-43.

[213] However, in practice, the court may stay further proceedings while plaintiff shareholders make the required demand. See, e.g., Elfenbein v. Gulf &Western Indus., Inc., 590 F2.d 445, 450 (2d Cir.1978).

[214] Anecdotal evidence strongly suggests that the board of directors normally refuse the demand. See Bainbridge, *Corporate Law* , above n 212, 233.

[215] John Matheson, 'Restoring the Promise of the Shareholder Derivative Suit', *Georgia Law Review,* 50 (2016), 327, 366.

The issue before the court is whether to honor the board of directors' refusal to bring suit or uphold the shareholder's assertion of futility of demand, and the court's finding can have a completely different effect on the ease of bringing a derivative action.

At one-time, these claim filing procedures were said to be mostly perfunctory in application.[216] Usually, the pre-suit demand was excluded if the misconduct at issue in the suit involved a member of the board of directors,[217] and up to the mid-1970s the federal courts engaged in a relaxed interpretation of the demand requirement so for the most part the satisfaction of the demand requirement was not disputed in litigation.[218] Delaware was also quite liberal in upholding futility of pre-suit demands. For example, precedent where the actions of a defendant director were subject to the suit has upheld exclusion of the pre-suit

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[216] Richard M. Buxbaum, 'Conflict-of-Interests Statutes and the Need for a Demand on Directors in Derivative Actions', *California Law Review,* 68/6 (1980), 1122-33, 1123. For a brief explanation of the history as for the demand requirement, see Takahashi, *Tajū Daihyō Soshō Seido No Arikata : HitsuyōSei to Seido Sekkei [Design of Double Derivative Actions-the Need and System Design-]* , above n 26, 126-28.

[217] Klein, Coffee, and Partnoy, *Business Organization and Finance : Legal and Economic Principles* , above n 108, 210; Buxbaum, 'Conflict-of-Interests Statutes and the Need for a Demand on Directors in Derivative Actions', above n 216, 1123.

[218] Davis, 'The Forgotten Derivative Suit', , 397-98; Takahashi, *Tajū Daihyō Soshō Seido No Arikata : HitsuyōSei to Seido Sekkei [Design of Double Derivative Actions-the Need and System Design-]* , above n 26, 126-27.

demand requirement due to futility.[219] Accordingly, the demand requirement was not significant untill the mid-1970s.[220]

Conversely, the state of precedent changed from the late 1970s.[221] The demand requirement evolved into the main substantive rule of derivative actions.[222] As I will demonstrate in detail below, the demand requirement began to function as a mechanism for honoring the determination of the board of directors regarding the key question of who should control derivative actions - the board of directors or the individual shareholders.[223]

The courts shifted their interpretation and began honoring the judgment of the board of directors in cases where, in line with the fundamental rule, a

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219 E.g., Fleer v. Frank H. Fleer Corp., 125 A. 411, 414 (Del. Ch. 1924); Miller v. Loft, Inc., 153 .861, 862 (Del. Ch. 1931). See John C. Coffee, 'New Myths and Old Realities: The American Law Institute Faces the Derivative Action', *The Business Lawyer,* 48/4 (1993), 1407, 1411-12.

220 Davis, 'The Forgotten Derivative Suit', above n 22, 398; Takahashi, *Tajū Daihyō Soshō Seido No Arikata : HitsuyōSei to Seido Sekkei [Design of Double Derivative Actions-the Need and System Design-]* , above n 26, 127.

221 Klein, Coffee, and Partnoy, *Business Organization and Finance : Legal and Economic Principles* , above n 108, 398; Takahashi, *Tajū Daihyō Soshō Seido No Arikata : HitsuyōSei to Seido Sekkei [Design of Double Derivative Actions-the Need and System Design-]* , above n 26, 127.

222 Bainbridge, *Corporate Law* , above n 212, 226. See Levine v. Smith, 591 A.2d 194, 207 (Del.1991) ("The demand requirement is not a 'mere formalit[y] of litigation,' but rather an important 'stricture[ ] of substantive law.'").

223 Ibid.

shareholder made a demand to the board of directors and the board of directors refused this demand. If the board of directors refuses a demand, the plaintiff shareholder must prove that the refusal was wrongful, but the business judgment rule applies to judgments of the board of directors.[224] Moreover, discovery is unavailable to plaintiff shareholders.[225] Additionally, under Delaware case law, a shareholder to make a pre-suit demand is deemed to have abandoned his/her dispute of the board of directors' independence.[226] The courts rarely find a board of director's refusal to be unreasonable if the board of directors is found to be independent.[227] The courts' tendency to honor a refusal by the board of directors removes the motivation for shareholders to make pre-suit demands. Instead, a reasonable shareholder will assert futility of demand and bring a derivative action without making a demand.[228] What has become important is the basis for judging

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[224] Spiegel v. Buntrock, 571 A.2d 767, 776 (Del. 1990); Aronson v. Lewis, 473 A2d 805, 813 (Del 1984); Zapata Corp. v. Maldonado, 430 A.2d 779, 784 (Del. 1981).

[225] Scattered Corporation v. Chicago Stock Exchange, 701 A.2d 70, 77 (Del.1997).

[226] John C. Coffee, ''New myths and old realities: The American Law Institute faces the derivative action', The Business Lawyer, 48 (4), (1993) 1407, 1413; Takahito Kato, 'Beikoku Ni Okeru Kabunushi-Daihyou-Soshou No Arikata Ni Kansuru Tyousa-Kenkyu-Gyoumu-Houkokusho [Report of the Survey and Research on Derivative Actions in the United States]', (Koueki-Shadan-Houjin Shouji-Houmu-Kenkyukai, 2017)., 8.

[227] Ibid.

[228] Matheson, 'Restoring the Promise of the Shareholder Derivative Suit', above n 195, 359; Bainbridge, *Corporate Law* , above n 212, 232.

whether a pre-suit demand will be excluded for futility.

In Delaware, the 1984 Aronson ruling established a judgment standard for the determination of futility. In the Aronson v. Lewis decision, the Delaware Supreme Court provided the test for demand futility as follows:

> *In determining demand futility the Court of Chancery in the proper exercise of its discretion must decide whether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.*[229]

The Aronson test was restated as follows in the Grimes v. Donald decision:

> *One ground for alleging with particularity that demand would be futile is that a "reasonable doubt" exists that the board is capable of making an independent decision to assert the claim if demand were made. The basis for claiming excusal would normally be that: (1) a majority of the board has a material financial or familial interest; (2) a majority of the board is incapable of acting independently for some other reason such as domination or control; or (3) the underlying transaction is not the product of a valid exercise of business judgment. If the stockholder cannot plead such assertions consistent with Chancery Rule 11, after using the "tools at hand" to obtain the necessary information before*

[229] Aronson v. Lewis, 473 A2d 805, 814 (Del 1984).

> *filing a derivative action, then the stockholder must make a pre-suit demand on the board.*[230]

These standards have made it so that a demand will not inevitably be excused simply because a majority of the directors are defendants. Additionally, even if a majority of the board of directors has approved a challenged transaction, such fact itself will not automatically excuse the demand.[231] Judgments of demand requirement futility are limited, for example, to those instances where a majority of the board of directors was dominated or controlled by someone with a personal financial stake in the transaction.[232] Under a third Grimes prong, a plaintiff shareholder is unable to utilise discovery and must use only the "tools at hand" prior to trial,[233] which renders it difficult for the plaintiff shareholder to allege facts giving rise to a reasonable suspicion that "the underlying transaction" was not the result of an appropriate business judgment. As such, most past derivative actions brought for mistaken business judgment have been dismissed

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230 Grimes v. Donald, 673 A.2d 1207, 1216 (Del.1996).

231 Aronson v. Lewis, 473 A2d 805, 814 (Del 1984); Takahashi, *Tajū Daihyō Soshō Seido No Arikata : HitsuyōSei to Seido Sekkei [Design of Double Derivative Actions-the Need and System Design-]* , above n 26, 127-28.

232 Aronson v. Lewis, 473 A2d 805, 814 (Del 1984); Bainbridge, *Corporate Law* , above n 212, 230.

233 Brehm v. Eisner, 746 A.2d 244, 249 (Del.2000).

pre-trial under the demand requirement procedures.[234]

The Aronson test is applied in instances where a director was involved in the "underlying transaction". However there are instances where the board of directors is not directly involved in the transaction or event at issue, and the question becomes whether or not they diligent in their duty of oversight. The Delaware Supreme Court presented the following standard for such cases in Rales v. Blasband:

> *Instead, it is appropriate in these situations to examine whether the board that would be addressing the demand can impartially consider its merits without being influenced by improper considerations. Thus, a court must determine whether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand. If the derivative plaintiff satisfies this burden, then demand will be excused as futile.*[235]

Rales v. Blasband was a case that involved a double derivative suit on behalf of a parent corporation, and the Rales upheld the application of the foregoing test for demand futility as follows based on the board of directors not

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[234] Thompson and Thomas, 'The Public and Private Faces of Derivative Lawsuits', , above n 24, 1783; Davis, 'The Forgotten Derivative Suit', above n 22, 427-28.

[235] Rales v. Blasband, 634 A.2d 927, 934 (Del.1993).

making a challenged business decision in the following three principle scenarios:

> *(1) where a business decision was made by the board of a company, but a majority of the directors making the decision have been replaced; (2) where the subject of the derivative suit is not a business decision of the board; and (3) where, as here, the decision being challenged was made by the board of a different corporation.*[236]

Under this standard, it is no easy task for a shareholder to base a derivative action alleging a breach of the duty of oversight by a director based on demand facility due to the applicable of the business judgment rule to the board of directors' refusal of the demand. Accordingly, the demand requirement has become a significant issue in derivative litigation.[237]

More recently, in the Zuckerberg 2021 case, the court refined the test for determining futility of a demand, with the following three-step test for each individual director:

> *(i) whether the director received a material personal benefit from the alleged misconduct that is the subject of the litigation demand; (ii) whether the director would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand; and (iii) whether the director lacks independence from someone who received a material personal benefit from the alleged misconduct that is the*

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[236] Ibid.

[237] Bainbridge, *Corporate Law* , above n 212, 226.

subject of the litigation demand or who would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand.[238]

This three-part test is applied to individual directors to check the futility of demand, and if a majority of the directors asked to consider the demand fail the three-part test, the demand is deemed to be futile[239]. This refined new test attempts to determine whether a director has a conflict of interest in determining the appropriateness of a derivative action by focusing on whether the director in question is likely to be held personally liable and whether he or she has an interest in a related party. As in Aronson and subsequent decisions, this decisional framework focuses on the director's conflict of interest.[240]

Special litigation committees (SLC) have been added as another tool for the control of litigation by the board of directors. SLC first appeared in the 1970s to counter the frequent occurring abusive or inappropriate filings of derivative actions.[241] In demand excused cases, the board of directors newly appoints independent members of the board of directors as members of the committee, and has the committee investigate the challenged transaction or event and consider

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[238] United Food & Commercial Workers Union & Participating Food Ind. Emp'rs Tri-State Pension Fund v. Zuckerberg, No. 404, 2020, A.3d, 2021 WL 4344361, 17 (Del.2021)

[239] Ibid, 17.

[240] Martin Gelter, 'Preliminary Procedures in Shareholder Derivative Litigation: A Beneficial Legal Transplant?', Fordham Law Legal Studies Research Paper No. 4030969, European Corporate Governance Institute - Law Working Paper No. 625/2022, (2022), 15.

[241] Bainbridge, Corporate Law, above n 212, 234.

whether or not the action was in the best interests of the company. The committee then makes a recommendation to the court based on the results of its findings. The rationale of SLC is to sort out abusive derivative actions by forwarding the pursuit of liability in meritorious suits and seeking the immediate dismissal of frivolous suits.[242] At issue is just how much the courts should honor the SLC recommendations.

The extent of the reviews conducted by the courts regarding a petition from SLC for the dismissal of suits varies from state to state.[243] In New York, for example, the court applied the business judgment rule to judgment of SLC in Auerbach v. Bennett.[244] Courts widely honor the judgments of SLC, and make a review only on SLC independence and the appropriateness of the collection of information, while the court does not examine whether or not the continuation of the suit would be desirable. Meanwhile, Massachusetts engages in relatively strict reviews of SLC judgments, and these reviews enter into the question of whether or not the suit would be appropriate going forward.[245] Underlying this is

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242 Ibid, 234-35.

243 Kraakman, Park, and Shavell, 'When Are Shareholder Suits in Shareholder Interests', above n 24, 1754-56; Jill E. Fisch, 'Teaching Corporate Governance through Shareholder Litigation', *Ga. L. Rev.,* 34 (2000), 745, 754-55; Black, Cheffins, and Klausner, 'Outside Director Liability', , above n 50, 1092; Erickson, 'Corporate Misconduct and the Perfect Storm of Shareholder Litigation', above n 24, 107-09.

244 Auerbach v. Bennet, 47 N.Y.2d 619 (1979).

245 Houle v. Low, 556 N.E.2d 51 (Mass. 1990).

concern that members of SLC appointed by the board of directors may be subject to "structural bias" and unable to make an appropriate determination of whether the continuation of the suit will benefit the shareholders.[246]

Delaware has adopted a middle ground position.[247] In particular, the Delaware Supreme Court rejected Auerbach's decision that a SLC's recommendation was protected by the business judgement rule in Zapata Corp. v. Maldonado.[248] Instead, in Zapata, the court adopted the following two-step test to determine whether or not a suit should be dismissed:

> *"First, the Court should inquire into the independence and good faith of the committee and the bases supporting its conclusions. Limited discovery may be ordered to facilitate such inquiries. The corporation should have the burden of proving independence, good faith and a reasonable investigation, rather than presuming independence, good faith and reasonableness."*[249]

If this first step is satisfied,

> *"(t)he Court should determine, applying its own independent business judgment, whether the motion should be granted. This means, of course, that instances could arise where a committee can establish its*

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[246] Takahashi, *Tajū Daihyō Soshō Seido No Arikata : HitsuyōSei to Seido Sekkei [Design of Double Derivative Actions-the Need and System Design-]* , above n 26, 129.

[247] Ibid, 129.

[248] Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).

[249] Zapata Corp. v. Maldonado, 430 A.2d 779, 788-89 (Del. 1981).

independence and sound bases for its good faith decisions and still have the corporation's motion denied."[250]

As such, the Zapata test calls for the court to make a substantial judgment on whether or not to uphold the continuation of a suit. In making this judgment, the court should carefully consider and weigh how compelling the corporate interest in dismissal is when faced with a non-frivolous lawsuit, and should, when appropriate, give special consideration to "matters of law" and "public policy" in addition to the corporation's best interests.[251] The Zapata decision likely refused to apply the business judgment rule to SLC recommendations due to concerns over structural bias at the litigation committee.

Accordingly, even though the extent thereof various from state to state, use of SLC has increased instances where derivative actions are dismissed. In reality, SLC are said to issue motions to dismiss in almost all cases,[252] and SLC have likely had a considerable effect on suppressing derivative actions.[253]

In the United States, the demand requirement has played a key role in holding back derivative actions, and even when successful in an allegation of demand futility, a shareholder still must overcome an SLC petition for dismissal of

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[250] Ibid.

[251] Ibid.

[252] Clark, *Corporate Law* , above n 7, 645; Klein, Coffee, and Partnoy, *Business Organization and Finance : Legal and Economic Principles* , above n 108, 212.

[253] Takahashi, *Tajū Daihyō Soshō Seido No Arikata : HitsuyōSei to Seido Sekkei [Design of Double Derivative Actions-the Need and System Design-]* , above n 26, 129-30.

the suit. In essence, this means that the board of directors is able to review whether derivative actions will be in the interest of the company and exercise major control over the question of whether or not a suit will be allowed to move forward. Underlying this is the fundamental principle that the management of the company should be left to the judgment of the board of directors.[254] In making a determination of the question of whether or not the pursuit of liability against a director will be in the interest of the company, consideration must be given to benefits gained through the suit and various costs incurred by the company in pursuing the action. Negative publicity to business partners and customer must be also considered in an examination of these costs.[255] This comprehensive consideration is similar in some aspects to the general issue of business judgment.[256] The demand requirement underlies this consideration, and derivative actions are only allowed in those instances where board of director's refusal of the demand is unreasonable or in those instances where an objective determination of whether or not the continuation of the suit would be best cannot be expected. The derivative action system in the United States is expected to

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[254] E.g., Del.Code Ann. Tit. 8, section 141(a); MODEL BUS. CORP. ACT section 8.01 (8b). See Kato, 'Guroup Kigyou No Kisei-Houhou Ni Kansuru Ichikosatsu (2) [an Inquiry into Legal Measures for Regulating Corporate Groups (2)]', above n 134, 1926.

[255] Gelter, 'Why Do Shareholder Derivative Suits Remain Rare in Continental Europe?', above n 21, 9-10.

[256] Ibid., 9-10; Kato, 'Guroup Kigyou No Kisei-Houhou Ni Kansuru Ichikosatsu (2) [an Inquiry into Legal Measures for Regulating Corporate Groups (2)]', above n 134, 1926.

function only in exceptional cases where the board of directors does not play its expected role in corporate governance.[257]

2.3.5. Empirical Studies in Derivative Actions in the US

As we have seen thus far, derivative actions have undergone a major repositioning in the United States. In the 1940s, derivative actions were affirmatively lauded for the role they played in corporate governance. Then, Mr. Franklin Wood conducted a study of the derivative actions filed in New York state courts and federal courts between 1932 and 1942 and found that the plaintiff shareholders prevailed in a very low percentage of the cases and that lawyers were acting as "ambulance chasers" to drive the filing derivative actions, and indicated that derivative actions were not necessarily functioning as intended.[258] Thereafter, lawyers continued to take the lead in the filing of number of derivative actions up through the mid-1970s, but in response thereto, the abusive or inappropriate filing of derivative actions began to be viewed as a problem and measures to suppress the filing of these actions were developed from the late-1970s. Measures that play a particularly important role were the pre-suit demand requirement and SLC. The number of derivative actions declined following the introduction of these control

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[257] Kato, 'Guroup Kigyou No Kisei-Houhou Ni Kansuru Ichikosatsu (2) [an Inquiry into Legal Measures for Regulating Corporate Groups (2)]', above n 134, 1928.

[258] Wood, *Survey and Report Regarding Stockholders' Derivative Suits* , above n 160.

measures and were replaced by an increase in the number of securities class actions.[259]

How then have derivative actions actually been utilised since the 1980s? The following prior empirical literature has studied the state of derivative actions in the United States.

First, Professor Roberta Romano conducted important research in which she examined all shareholder suits filed from the late 1960s through 1987 against a sample of 535 public companies, randomly selected from firms currently traded on the New York Stock Exchange and over-the-counter in the National Association of Securities Dealers Automated Quotation National Market System, and from firms that have ceased trading in those markets.[260] Professor Romano reported that a majority of the cases ended in settlement (83 of 128 resolved suits), and that the plaintiff shareholders failed to prevail and were not awarded compensation or equitable relief and any of the other cases did not end in settlement (approximately one-third of all the cases). However, this study covered both derivative actions and class actions, and did not clarify the number of derivative actions included in the overall cases. Limited to the derivative actions, it was found that companies

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[259] Stephen J. Choi and Robert B. Thompson, 'Securities Litigation and Its Lawyers: Changes During the First Decade after the Pslra', *Columbia Law Review,* 106/7 (2006), 1489-533, 1492. The abusive filing of securities class actions gathered scorn so the government stepped in and intervened with the enactment of the Private Securities Litigation Reform Act of 1995.

[260] Romano, 'The Shareholder Suit: Litigation without Foundation?', above n 30.

provided monetary recoveries to the plaintiffs in 12 cases. In 11 of the derivative suites with monetary recovery the average recovery was only $0.18 a share ($0.15 net of lawyers' fees), which is 2 percent of the stock price on the day prior to the actions' filing. Based on her data, Professor Romano pointed out that derivative actions served only a very limited compensatory function.[261]

Additionally, this study found that settlements that included board composition changes, executive compensation changes, defensive tactic restrictions, self-interested transaction restrictions and other corporate governance efforts were reached in 25 cases.[262] Professor Romano pointed out that "while it is impossible to value the benefits from structural settlements with any precision, the gains seem inconsequential." and that promising governance efforts may be "potentially important reform" but is sometimes just "cosmetic organisational change."[263] She also posits that the settlements related to governance may be a means for concluding the action so that the company covers the plaintiff's lawyers' fees.[264] Actually, Professor Romano showed that plaintiffs' lawyers enjoyed an average of USD 1.45 million in actions ending by settlements with monetary reliefs and an average of USD 287,000 in actions ending by non-monetary settlements.[265] The high fees earned by lawyers in derivative actions resolve the economic incentive

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[261] Ibid, 62.

[262] Ibid, 63.

[263] Ibid, 63.

[264] Ibid, 63.

[265] Ibid, 63.

issue for plaintiffs and ensure a real possibility of the filing of derivative actions. Conversely, however, an agency problem arises in derivative actions that are contrary to the interests of the company, and Professor Romano's study suggests that this harm would be real.

Next, Randall Thomas and Robert Thompson investigated shareholder suits brought in the Delaware Court of Chancery in 1999 and 2000.[266] In their study the first excluded actions with overlapping content and found that of the 348 total cases, 223 involved class actions, 84 involved derivative actions and 74 involved direct actions.[267] The authors also confirmed that approximately thirty derivative actions are filed per year in the Delaware Court of Chancery against public companies incorporated in Delaware, and pointed out that such number was not a significant.[268] They also confirmed that non-monetary resolutions were reached in the majority of the cases they studied which ended in settlement. The authors stated that they were unable to find evidence indicating that the majority of the derivative actions against public companies were "strike suits" yielding little benefit.[269] Rather the companies provided relief to shareholders in approximately 30% of the derivative actions against public companies, and the remaining cases

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[266] Thompson and Thomas, 'The Public and Private Faces of Derivative Lawsuits', above n 24.

[267] Ibid, 1762.

[268] Ibid, 1749.

[269] Ibid, 1749.

were hastily dismissed.[270] They also reported that many of the allegations in class actions identified breaches of a director's duty of care in mergers and acquisitions, while many of the allegations in derivative actions identified conflicts of interests between shareholders and management or conflicts of interests between controlling shareholders and minority shareholders.[271] Based on this, the authors deduced that "plaintiffs' lawyers will only choose to file a derivative case when they either are certain they can satisfy the demand requirement or have no other possible venue or type of claim to file. If this were so, we would expect to find that most public company cases are brought where demand is excused and that there would be relatively low levels of litigation over the demand requirement."[272] The results of this study affirmed that the demand requirement and SLC have widely prevented the abusive or inappropriate filing of derivative actions while ensuring a real possibility of meaningful derivative actions over conflicts of interests.

Jessica Erickson recently conducted empirical research in which she exhaustively studied derivative actions filed in federal court from July 1st, 2005 through June 30th, 2006.[273] Her study revealed that a total of 182 actions were filed in federal court in a one year period.[274] Out of the 182 cases in the study,

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[270] Ibid, 1749-50.

[271] Ibid, 1773-74.

[272] Ibid, 1773-74.

[273] Erickson, 'Corporate Governance in the Courtroom: An Empirical Analysis', above n 38.

[274] Ibid, 1758.

141 (77.5 percent) were filed against public companies, which, involved a total of 126 different companies, while the remaining 41 actions were brought on behalf of a total of 45 private companies.[275] More than four times more actions are filed in federal court than in the Delaware Court of Chancery.[276] This study showed that derivative actions have not disappeared, but that they have moved into the federal courts.[277] No one would say that 141 derivative actions filed against 126 public companies in the one year period is a small number.

Of the 141 derivative actions against public companies, shareholders received meaningful financial benefits from companies in only 22 cases (6%).[278] Almost all of the cases that reached a monetary settlement dealt with allegations that the defendants had backdated stock options, which was a major social problem at the time.[279] Only one other case ended in a monetary settlement. Based on this, the author pointed out that "In short, this study found relatively few monetary settlements, and the cases that did end with monetary settlements tended to involve very different allegations than the more typical derivative suits. Although these studies stretch over nearly 70 years, they reach the same conclusion. Derivative suits, unlike most lawsuits, rarely end with the plaintiff receiving money."[280]

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275 Ibid, 1770.

276 Ibid, 1762.

277 Ibid, 1761.

278 Ibid, 1799.

279 Ibid, 1799.

280 Erickson, 'The (Un)Changing Derivative Suit'., above n 161, 61.

Additionally, 34 (24%) of these 141 cases ended by settlements with non-monetary relief. Based on the following features, as in the Romano study, these settlements were found to be mostly meaningless for shareholders. First, in many cases the governance reform promised in the settlement is unrelated to the dispute in the derivative action. Second, the settlements were similar in nature in that they were unrelated to the disputes in the action. Third, the increased shareholder value from the governance reform cannot be empirically confirmed, and questions remain regarding the meaningfulness of settlements for shareholders.[281] Based thereon, it would be possible that many of the settlements containing governance reform are "window dressing" which make it possible for defendant directors to conclude the action without substantial economic harm and which function as a tool for plaintiff's lawyers to earn high fees.[282] Actually, her study found that in the cases ending with a meaningful financial benefit, the median lawyers' fees were USD 6.65 million and that in the cases ending with non-monetary settlements including only the reform of corporate governance policies, the median fees were USD 460,000.[283]

Additionally, in a separate study Jessica Erickson revealed that approximately 95 percent of the derivative actions involving public companies were accompanied by at least one "parallel" securities class action or government

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[281] Ibid, 1823-24.

[282] Ibid, 1824.

[283] Ibid, 1806.

investigation,[284] and that while the median amount of monetary recovery in settlements of the parallel securities class actions was USD 18 million, no derivative actions in the study ended by settlements with anything close to this number.[285]

In a more exhaustive study, Stephen J. Choi, Jessica Erickson and A. C. Pritchard looked at a sample of 582 securities class actions filed against public companies between July 1, 2005 and December 31, 2008, and examined all derivative and class actions arising out the same underlying allegations.[286] This study revealed that 45.4 percent of the securities class actions had a parallel derivative actions or class actions, and that a majority of these parallel actions are filed in the federal courts.[287] They also confirmed that parallel actions tended to end in settlements promising corporate governance reforms with lower monetary recoveries for plaintiff shareholders.[288] What should be noted is that the derivative actions that ended by non-monetary settlements had no economic benefits for the plaintiff shareholders but produced considerable fees for lawyers in

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[284] Jessica Erickson, 'Overlitigating Corporate Fraud: An Empirical Analysis', *Iowa Law Review,* 97 (2011), 49-100, 4.

[285] Ibid, 31.

[286] Stephen J. Choi, Jessica Erickson, and Adam C. Pritchard, 'Piling On? An Empirical Study of Parallel Derivative Suits', *Journal of Empirical Legal Studies,* 14/4 (2017), 653-82.

[287] Ibid, 663.

[288] Ibid, 673.

short-term cases. The authors pointed out that actions piggybacking on securities class actions produced nearly no value for shareholders, that derivative actions do not contribute in revealing new unknown misconducts, and that derivative actions are filed as a tag-along piggyback to increase opportunities for lawyers to earn fees. [289]

The defendant in a securities action is the company while the defendant in a derivative action is an individual director, and because of this the filing of a derivative action in addition to a securities action may serve as a strong deterrence for the individual director. However, for the most part there have been no derivative actions in which individual directors have provided compensation.[290] Additionally, individual directors who engage in misconduct are subject to public enforcement by the Securities & Exchange Commission and the Department of Justice. Considering that derivate actions only piggyback on parallel class actions or public enforcement and result in no benefits for shareholders, it can also be assumed that "in the hierarchy of corporate lawsuits, derivative suits may well be at the bottom."[291]

As demonstrated above, a considerable number of derivative actions continued to be filed. With regard to the question of how the demand requirement

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[289] Ibid. See also Erickson, 'The (Un)Changing Derivative Suit'., above n 161, 61-2.

[290] Erickson, 'Corporate Governance in the Courtroom: An Empirical Analysis', above n 38.

[291] Erickson, 'The (Un)Changing Derivative Suit'., above n 161, 63.

and SLC are functioning, The Erickson study found that of the 173 cases (182 derivative actions filed in federal courts less 9 cases brought on behalf of foreign companies), the Plaintiff shareholders made pre-suit demands in 36 cases (20.8%) and asserted the futility exception without making pre-suit demands in the remaining cases (approximately 80%).[292] Additionally, only 25 cases were dismissed for the failure to meet the demand requirement, i.e. the futility exception was not upheld in only 25 cases.[293] Pre-suit demands were made and rejected by the board of directors, and their determination was protected under the business judgment rule in only five cases.[294] This reveals that while the demand requirement is an important issue in the federal courts where most derivative actions are filed, the plaintiff's demands are dismissed in only a portion of these cases based on the demand requirement. Similarly, though many companies have established SLC, it was confirmed that the determinations of SLC do not directly lead to the conclusion of actions.[295]

2.3.6. Summary

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[292] Erickson, 'Corporate Governance in the Courtroom: An Empirical Analysis', above n 38, 1782.

[293] Ibid, 1783-84.

[294] Ibid, 1784.

[295] Ibid, 1784-87; Minor, 'The Decisions of the Corporate Special Litigation Committees: An Empirical Investigation', above n 119.

As addressed above, the United States established a system to ensure economic incentives for lawyers in order to promote the filing of derivative actions, but this was plagued by the side effect of the litigation agency problem. The demand requirement and SLC were developed as means to control the filing of actions, and function as an opportunity for the board of directors to determine whether the action is necessary and appropriate for the interests of shareholders. Empirical research has shown that the derivative actions filed are not directly dismissed under the demand requirement or SLC, and has confirmed that the derivative actions filed (i) often piggyback on securities class actions or public enforcement, (ii) do not give economic value to shareholders, (iii) end by settlements that promise cosmetic governance reforms, and (iv) make it so that lawyers are the only ones who earn economic benefits. Though a derivative action system is put in place and the real threat of derivative actions may serve as a deterrence and functions in the production of legal rules in the United States, the oversight by the courts must be strengthened and other policies must be put in place to control collusive settlements which work to the economic benefit of only the lawyers.

2.4. Suggestions Derived from the State of Use of Derivative Actions in the UK and the US

Up to now in this chapter, we have looked at the state of the use of derivative actions in the UK and the US. Based on that analysis, the following perspectives

are important to attain with regard to the purposes of this thesis.

First, it is important that the expectations for the derivative action system change in relation to the other tools available for corporate governance. In the UK, in the past discipline of management through engagement by institutional investors has been effective, while expectations for legal enforcement through derivative actions have been weakened. However, with increasing shareholding ratios by overseas institutional investors and weakening engagement by institutional investors, it has been pointed out that use of derivative actions should be promoted more.[296]

In the US, because in the past there was a time when the significance of the existence of derivative actions was thought of as positive for the strengthening of corporate governance, but there has been a heightened negative outlook on the abuse of derivative actions, from around the mid-1970s measures have been put into place to suppress litigation claims and SLC in advance. Since the 1970s, this has overlapped in time with the advance of governance reforms oriented towards monitoring boards which utilise outside directors. It is thought that the strengthening of the management and supervision functions of boards of directors may likely have chilled expectations for derivative actions. Together with that fact, it is thought that mainstream opinion has not coalesced in favor of the revitalisation of the use of derivative actions.

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[296] John Armour, "Derivative Actions: A Framework for Decisions" (2019) 135 Law Quarterly Review 412.

Second, while derivative actions are expected to serve functions in the recovery of damages, the prevention of illegal behavior, the creation of legal rules and the like, they have had detrimental side effects including, among others, increasing the burden of responding to litigation for companies and defendant directors, and producing conflicts of interest between the plaintiff shareholders and other shareholders. There is a need to realise the right balance through the promotion of the filing of desired derivative actions and the suppression of the filing of undesired derivative actions. The issue is then who will determine what derivative actions are desirable and from what perspective. In the UK, the courts play a role as a gatekeeper, and a determination is made as to whether to permit the continuation of a derivative action by focusing on the perspective of "will the derivative action be conducive to the interests of the shareholders?" On the other hand, in the US, a structure for advance litigation claims, SLC and the like is established to secure independence, and a determination on the appropriateness of the filing or continuation of a derivative action is made by a board of directors comprised of uninterested outside directors. The determination criteria therefor focuses on the conflicts of interest of directors, and the perspective of the shareholders' interests is not a central issue. This, in contrast, suggest that there could be a variety of people who make the determinations and a variety of determination criteria in the screening of derivative actions as well.

Third, the consequences brought about through the screening of derivative actions is also important. In the UK, the question of whether or not to permit the

continuation of a derivative action focuses on the perspective of the interests of the shareholders. However, based on self-reflection that they lack expertise in rendering business judgements, the courts tend to be humble in determining whether a derivative action contributes to the interests of shareholders.[297] As a result thereof, in cases where the duty of care is at issue, the courts are reluctant to issue permission for the continuation of derivative actions, and may create a trend where permission is only issued in those instances where there are conflict of interest dealings or clear illegal behavior. Additionally, in the US, determinations over the futility of demands are focused on the directors' conflicts of interest. As a result, it is easy to demonstrate the futility of a demand in cases where the breach of the duty of loyalty is at issue, but also may lead to a tendency to not often bring this up in cases where the duty of care is at issue.[298] As such, depending on the method of screening, if there are breaches of the types of duties where it is easy to utilise derivative actions and breaches of the types of duties where this is difficult, there may also be biases in the functions that can be realistically fulfilled by derivative actions. Under the current situations in the UK and the US, it is possible to assess that the function that is actually being served by derivative actions is limited to the recovery of damages and prevention with regard to breaches of the duty of loyalty.

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[297] Ibid, 427-428

[298] Thompson and Thomas, 'The Public and Private Faces of Derivative Lawsuits', above n 24, 1775.

Fourth, while along similar lines to the third point, it is important that the function of derivative actions be limited through screening. In the UK, a determination on permitting continuation of an action is made from the point of view of "whether the continuation of the derivative action is conducive to the interests of the shareholders" and "whether the shareholders believe that the derivative action is necessary." In instances where the determination is made by emphasising these shareholder interests or intent, the function of the special nature of positive externalities, in an economic sense, is not taken into consideration. In particular, general deterrence and the creation of legal rules go above and beyond the interests of the company, and have a general effect on society, and are not given sufficient consideration under the determination criteria of "will the derivative action be in the interest of the company at the moment." In result, the pace of use of derivative suits remains low, whereby general deterrence, the creation of legal rules and the like may not be sufficiently stimulated. Of course, a variety of corporate governance tools are expected to have a disciplinary effect on management, and the code of conduct for directors is expected to be specified through guidelines and soft laws. The relation with other system is also important in the question of how much general deterrence and creation of legal rules can be expected from derivative actions.

2.5. Conclusion

As we have seen above, at one time derivative actions were highly valued in the United States, but subsequently came under increased criticism of abuse due to the large number of lawyer-driven actions, giving rise to the demand requirement and SLC control measures. Questions persist even now as to whether derivative actions exert an independent effect since a large number of actions continue to be filed, especially in federal courts, and often tag-along piggyback on securities actions or public enforcement. Meanwhile, derivative actions have not historically been widely utilised in the United Kingdom where framework has been put in place for courts to examine the interests of companies in determining whether or not to allow a derivative action to continue. Additionally, incentive problems will likely hinder the amplified use of derivative actions in the future. The expansion of public enforcement, shareholders engagement and other substitutes may have diminished the need for general deterrence through derivative actions. Next, we are faced with the question of how derivative actions have developed in Japan. Derivative actions in Japan were initially patterned on the United States model, but unlike the United States and the United Kingdom, no safeguard measures have ever been put in place to address the litigation agency problem. We will examine this history in the next chapter.

CHAPTER III: EXPLORING DERIVATIVE ACTIONS IN JAPAN

3.1. Introduction

Chapter I examined the theoretical functions and the cost of derivative actions in the context of corporate governance. It demonstrated that while functioning as a remedy to mitigate the agency problems between the directors and the company, derivative actions create another agency problem between the self-selected plaintiff shareholders and the company. It suggested the need for the facilitation of derivative actions as an effective deterrent tool by holding the directors accountable as well as the adequate safeguards against their undesirable actions. Chapter II examined the policy and the practice of derivative actions in the US and the UK in order to provide benchmarks for those in Japan. It demonstrated that while the demand requirement and the special litigation committee have served as measures for sorting out the agency problem between the self-selected plaintiff shareholders and the company in the US, derivative actions have been rarely used because of the considerable difficulty in receiving the court's permission to bring actions on behalf of the company in the UK. This chapter now turns to analytically trace the development of derivative actions in Japan, especially taking into account two factors: (i) "accessibility" of derivative actions for a shareholder; and (ii) "safeguards" against unnecessary or illegitimate actions.

Japan transformed the regime of corporate law from the German model into the US model in 1950. Before the 1950 revision, minority shareholders had considerably limited rights to hold the directors accountable. The 1950 revision, which sought to strengthen the rights of the minority shareholders, introduced derivative actions into the Commercial Code. As will be seen, the Code granted shareholders the right to easily bring a derivative action. It should be also noted that while the Code authorises the court to order a plaintiff seemingly without sufficient evidence or legal grounds to provide reasonable security,[299] it does not implement measures for tackling with the agency problem of the self-selected plaintiff shareholders.

However, notwithstanding easy access as compared to derivative actions in the US and the UK, derivative actions were scarcely used until the 1990's. During this period, the court practice, in which a plaintiff shareholder had to bear the burden of paying a possibly substantial litigation fee, functioned as a serious impediment to bringing a derivative action. After the court practice regarding the litigation fee was changed in 1993, so that a plaintiff shareholder was required to pay only a low fixed amount of the fee,[300] the number of derivative actions

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[299] The 1951 Code ss 267 (4) and (5), Companies Act 2005 ss 847 (7) and (8). As will be seen, the authority of the court to order providing bond was implemented in the 1951 revision.

[300] The amount was then only JPY 8,200 (around GBP 50 as of 8th January 2016), which was increased to JPY 13,000 in 2004 (around GBP 80 as of 8th January 2016) due to the revision of Act on Costs of Civil Procedure (Act No.40 of 1971)

increased considerably.[301]

Given that the Japanese derivative action lacks sufficient safeguards except for the court order for a plaintiff to provide reasonable security, Japanese companies would potentially suffer from many unnecessary or illegitimate derivative actions brought about by the self-selected plaintiff. It is, however, interesting to note that, in Japan, a significant proportion of commercial litigation is said to occur in closely held companies,[302] and it can be expected that only a few listed companies face a derivative action claim every year. Assuming this preliminary observation holds true, not only does it suggest that Japanese companies need not be concerned about the excessive use of derivative actions, but it also indicates that the free rider problem inherent in derivative exists in Japan.[303] Given the fact that the attorneys, who are possibly the principal entrepreneurs in derivative actions, cannot expect attractive returns in Japan, it seems reasonable to form a hypothesis that, while the Japanese Commercial Code provides a shareholder with easily accessible derivative actions, the lack of incentive for a plaintiff and its attorney cause under-enforcement of derivative actions.

The chapter continues as follows. Section 3.2 describes the limited power of the minority shareholders to enforce the liabilities of the directors before 1950.

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301 See a chart below under 3.4.2.

302 Akiyo Fukui, 'Kaishahou Sekougono Kabunushi-Daihyou-Soshou No Gaikyou [the General Report on Derivative Actions after the Enforcement of the Companies Act]', *Shiryouban Shoujihoumu,* 334 (2012), 72, 74.

303 See discussions on the free rider problem in Ch II above under 1.3.3.

Section 3.3 describes the introduction of derivative actions in the 1950 revision, and points out the basic features of the Japanese derivative action, in which the shareholders are, in theory, conferred strong power to enforce the liability of the directors on behalf of the company. Section 3.4 describes the scant use of derivative actions before the 1990's, and suggests that the court practice regarding the litigation fee served as a practical obstacle for the shareholders who intended to bring a derivative action. While the number of derivative actions increased substantially after the obstacle of the litigation fee was removed in 1993, Section 3.5 discusses the possibility of the under-enforcement of derivative actions in Japan due to the lack of incentive for a potential plaintiff and its attorney.

3.2. Limited Power of Shareholders Before 1950

The regime of corporate law in Japan changed dramatically before and after 1950: from the regime of German law to that of US law. The Commercial Code (Law No.48 of 1899) was enacted and enforced in 1899 in Japan. The Code was originally drafted mainly based on German law.[304] In the aftermath of World War

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[304] For an outline of the Japanese Commercial Code, see Hiroshi Oda, *Japanese Law* (3rd edn.: OUP, 2009), 117. For a basic introduction on Japanese legal system and private law legislation, and the history of the Japanese Commercial Code, see Tomotaka Fujita, '"De-Codification" of the Commercial Code in Japan', *GCOESOFTLAW-2012-5 (Global Centers of Excellence Program, Graduate Schools for Law and Politics, The University of Tokyo, Discussion Paper Series)*

II, the Code saw a series of significant revisions in 1948, 1950, and 1951 under the strong influence of General Headquarters ("GHQ"), Supreme Commander for the Allied Powers ("SCAP").[305] Of these amendments, it was the 1950 revision that played a major role in the turnaround of the Commercial Code. The 1950 revision adopted several important legal arrangements peculiar to US corporate law, including the authorised capital, the board system and derivative actions.[306]

Before the 1950 revision, the Code granted minority shareholders a very limited judicial venue to challenge the decisions of directors.[307] In particular, the

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<http://www.gcoe.j.u-tokyo.ac.jp/pdf/GCOESOFTLAW-2012-5.pdf> accessed 8 January 2016, (2013b).

[305] For an explanation of the involvement of GHQ, see Lester N. Salwin, 'The New Commercial Code of Japan: Symbol of Gradual Progress toward Democratic Goals', *Geo. L. J.,* 50 (1962), 478. The author worked as Special Assistant for Legal Affairs to Chief, Economic and Scientific Section, and Chief, Trade Laws Branch, General Headquarters, Supreme Commander for the Allied Powers, during the period of 1946-1952. For a detailed examination on the course of the 1950 revision based on documents of GHQ/SCAP, see Masafumi Nakahigashi, *Shoho Kaisei (Shouwa 25 Nen-26 Nen) Ghq/Scap Bunsho [the Revision of the Commercial Code in 1950-1951: Ghq/Scap Documents]* (1st edn.: Shinzansha, 2003).

[306] For a detailed description of the 1950 revision written in English, see Salwin, 'The New Commercial Code of Japan: Symbol of Gradual Progress toward Democratic Goals', above n 305.

[307] For details of legislative changes based on (i) Index of anti-director rights, (ii) Index of disclosure requirements, (iii) Index of liability standards, (iv) Index of public enforcement, and (v) Index of creditor rights over the period from 1899 to today using

Code did not provide the shareholders with the right to bring a derivative action. It was practically impossible for minority shareholders to directly enforce the liability of directors even if there was seemingly sufficient evidence to show the wrongful or unauthorised acts of the directors.

To illustrate the difficulties faced by minority shareholders, consider the case in which the directors or auditors did not bring a liability claim against the directors who had obviously breached their duties to the company. (See Figure 1.) Under the Commercial Code before the 1950 revision, the first step of the shareholders was to demand that the directors should convene a shareholders' meeting by showing that the purpose of the shareholders' meeting shall be the matter of bringing an action against the directors. The demand for the convocation of a shareholders' meeting was conditioned on a threshold requirement of having ten percent or more of all issued shares.[308] The minority shareholders who held less than ten percent could not initiate an action at all. The second step was to obtain the approval of shareholders at a shareholders' meeting with respect to the matter of bringing an action against the directors. If an approval resolution was made at the meeting, the company could then bring a claim against the directors within one month from the

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classification of Rafael La Porta et al., 'Law and Finance', *Journal of Political Economy,* 106 (1998), 1113. See also Julian Franks, Colin Mayer, and Hideaki Miyajima, 'The Ownership of Japanese Corporations in the 20th Century', *Review of Financial Studies,* 27 (2014), 2580. They suggest that the LLSV scores increased from one in 1900 to four in 1990 after the revisions of the Commercial Code in 1950 and 1974.

[308] Pre-1950 Code, s 237 (1).

date of the resolution.[309] However, although the matter could be resolved by a majority not of all issued shares but just of the shares that were voted at the shareholders' meeting,[310] it would be fairly demanding for the shareholders to gain even such majority support. As the final step in the case in which the shareholders failed to make a resolution to bring an action against the directors at the meeting, the shareholders may have demanded, within three months after the date of the general meeting of shareholders, that the company should take an action against the directors. Shareholders seeking to do so, however, had to meet the extremely high threshold of having ten percent or more of all issued shares consecutively for the preceding three months or longer.[311] It was reported by Mr. Kurt Steiner, Legislation and Justice Division of GHQ/SCAP, that these provisions were so restrictive that, according to the Economic and Scientific Section of GHQ ("ESS"), actions initiated by the shareholders had rarely been seen.[312]

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[309] Pre-1950 Code, s 267 (1).

[310] Kenichi Okuno and Et Al., *Kabusiki Gaisha Hou Shakugi [the Commentary of the Company Law]* (1st edn.: Ganshodo-shoten, 1939), 182.

[311] Pre-1950 Code, s 268(1).

[312] Kurt Steiner (Legislation and Justice Division of Ghq/Scap), 'Memorandum for the Record on the Subject of Revision of the Commercial Code as of 27 June 1949', (1949), printed in Nakahigashi, *Shoho Kaisei (Shouwa 25 Nen-26 Nen) Ghq/Scap Bunsho [the Revision of the Commercial Code in 1950-1951: Ghq/Scap Documents]* , above n 279, 126.

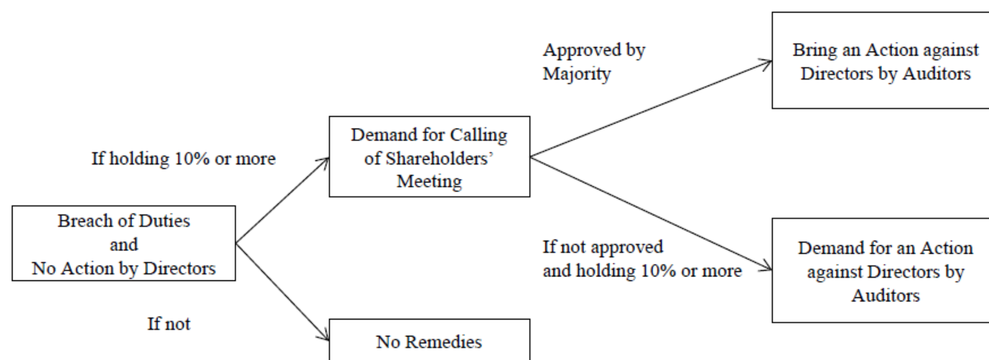

Figure 1

Furthermore, it should be stressed that, while there was a venue for shareholders to demand that the company should bring a claim against the directors via the resolution made at the shareholders' meeting or via the possession of no less than ten percent of the outstanding capital, it was not the shareholders but rather the auditors, in principle, who brought the action on behalf of the company.[313] The Commercial Code then provided that the auditors (*kansayaku*) not only financially audited the company's books but also checked the activities of the company's management.[314] It was, however, suggested that the auditors, in practice,

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[313] Pre-1950 Code, s 277(1). There were two exceptions for the rule that the auditors represented the action against directors. Firstly, Pre-1950 Code, s 277 (1) provided that the general meeting may appoint a representative. Secondly, Pre-1950 Code, s 277(2) allowed the shareholders who demanded the auditors to bring the action to designate a representative. However, individual shareholders were not allowed to bring an action on behalf of the company at all in any case. See Joichi Okazaki, *Shin Kaishaho to Sekouho [New Company Law and Act for Enforcement]* (1st edn.: Gakuyou-shobo, 1951), 94.

[314] For example, before the 1950 revision, the auditors may, at any time, demand that the directors submit a business report and investigate the company's affairs and the state of its property. See Pre-1950 Code, s 274. After the 1950 revision, the scope of the auditors' authority was narrowed and then extended. At first, the 1950 revision limited the scope of

performed their expected role poorly. For example, Steiner pointed out as follows:

> ESS felt strongly…that the check by the auditors in particular is purely fictitious since the auditor is actually a puppet for the management and therefore ineffective as a control organ. In addition, he is elected by the majority of the shareholders and could hardly be counted on to safeguard the interests of any minority.[315]

As Steiner suggested, it seems reasonable to assume that the auditors did not have an incentive to seriously bring an action against the directors who elected the auditors de facto. The shareholders, however, were not authorised to interfere with the auditors' course of action, and they did not have any remedies to effectively prevent the collusive actions of the auditors.

It, thus, can be concluded that minority shareholders had substantially

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the audit to only an audit related to accounting, taking into account the fact that it incorporated the board system and strengthened the shareholders' rights and, therefore, the need of the additional check by the auditors on the management activity was reduced. However, in the 1974 revision, the authority of the auditors was extended again beyond a financial audit to an audit related to the management activity. After the 1974 revision, auditors check the management activity in terms of the director's compliance with the applicable laws, the company's charter, and their fiduciary duties.

[315] Steiner (Legislation and Justice Division of Ghq/Scap), 'Memorandum for the Record on the Subject of Revision of the Commercial Code as of 27 June 1949'., above n 312.

limited power to enforce the liability of the directors before the 1950 revision, taking into account (1) the complicated manner in which shareholders seeking to do so had to convene a shareholders' meeting as the first step, (2) the extremely high threshold of ten percent for the requirement to convene a shareholders' meeting and demand that the company should bring a claim against the directors in case of the failure to reach a resolution at the meeting, and (3) the lack of derivative actions, which meant that the auditors, who were seemingly elected de facto by the directors, rather than the shareholders would bring an action without any intervention of the shareholders.

3.3. Introduction of Derivative Actions in the 1950 Revision

3.3.1. Formalistic Prerequisite and Accessible Procedures

The policy was completely changed in the 1950 revision. The 1950 revision introduced derivative actions for the first time. The new regime allowed any shareholder to bring a claim against the directors on behalf of the company in cases where the company had not taken an action against the directors who the shareholder believed had a legal liability to the company.[316]

Before analysing the characteristics of the Japanese derivative action, it is worth drawing up a brief outline of its fundamental structure. (See Figure 2.) First,

[316] The 1950 Code, ss 267 (1) and (2), Companies Act 2005, ss 847 (1) and (3).

it allows any shareholder who has held at least one share consecutively for six months to bring a derivative action.[317] All a shareholder has to do is to demand, in writing, that the company bring an action against the directors. In cases in which the company has failed to institute such action within 60 days from the date on which the demand was made by the shareholder, the shareholder may bring a claim on behalf of the company.[318] As will be seen below, the procedures for bringing a derivative action are quite straightforward and easily accessible to the shareholders compared with other jurisdictions as can be seen next.

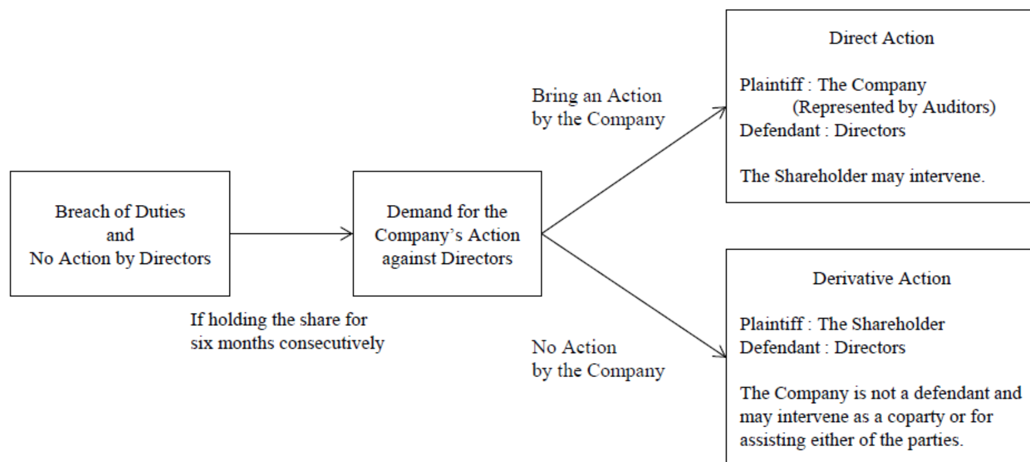

Figure 2

(1) Standing

The eligibility of filing a derivative action is granted to a shareholder who has held shares consecutively for the preceding six months or longer.[319] It has generally been acknowledged that a shareholder may bring an action

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[317] Ibid.

[318] Ibid.

[319] Ibid.

concerning wrongs committed prior to his/her holding shares,[320] based on the concept that derivative actions are brought not in the interests of a plaintiff shareholder himself/herself but rather in the interests of the shareholders as a whole. It is also conceded that a plaintiff should maintain his/her shares until the court renders a final and binding decision. If a plaintiff shareholder leaves the company during the pendency of an action, he/she is, in principle, no longer granted standing and, therefore, the court shall dismiss the case.

(2) Shareholder's Demand

As the first step to bring an action, a shareholder must demand in writing that the company file an action for pursuing the liability of a director.[321] When the company fails to file such action within 60 days from the day of the demand, the shareholder may file such action on behalf of the company.[322]

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[320] While this is the same as s 260(4) of the UK's Companies Act2006, the US adopts the "contemporaneous ownership rule", in which a plaintiff must have been a shareholder at the time of wrong-doing.

[321] The 1950 Code, s 267 (1), Companies Act 2005, s 847 (1). As an exception for this rule, a shareholder may immediately file an action against a director in cases where the company is likely to suffer irreparable harm through the elapse of the waiting period of 30 days. See the 1950 Code, s 267 (3), Companies Act 2005, s 847 (5).

[322] The 1950 Code, s 267 (2), Companies Act 2005, s 847 (3). The period for which the shareholder should wait for initiating an action was extended from 30 days to 60 days in the 2002 revision. See the 2002 Code, s 267 (3).

On the other hand, if the company initiates such an action, the shareholder is no longer eligible to bring a derivative action, and the auditors represent the company in the action.[323] In such a case, the shareholder may intervene in the action that has been brought by the company so as to prevent a collusive action.[324]

(3) Defendant and the Company's Intervention

A director named as a defendant by a plaintiff, by definition, is made a defendant to the claim. It is also the case that a shareholder may bring an action against a former director.[325]

It would be surprising to scholars and practitioners in other jurisdictions that the company is not made a defendant in a derivative action case in Japan. Even though the company is not involved as a defendant, the Code of Civil Procedure rather than the Commercial Code provides that a final and binding

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[323] Companies Act 2005, s 386 (1). The 1950 Code, s 261-2 (1) provided that not auditors but the person designated by the board represented the company in actions between the company and directors because the scope of the authority of auditors was limited to accounting audit in the 1950 Code. However, the 1974 revision of the Code extended the scope of the authority of auditors to auditing the execution of duties by directors, and revised relevant provisions so that the auditors would represent the company in such actions. See the 1974 Code, s 275-4.

[324] The 1950 Code, s 268 (2), Companies Act 2005, s 849 (1).

[325] Kenjiro Egashira, *Kabushikigaishahou [Laws of Stock Corporations]* (7th edn.: Yuhikaku, 2017), 494-495.

judgment shall be effective against the company on the grounds that a plaintiff shareholder has served the company.[326]

Instead, the company may intervene in an action that has been brought by a shareholder either as a "co-party" or to assist either of the parties.[327] The shareholder should give notice of the action to the company without delay after filing an action so that the company makes a decision about whether or not it will intervene in the action.[328]

(4) Scope of Liability

A derivative claim may be brought concerning the liability of a director to the company.[329] The Code does not put any limitations on the types of

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326 The Code of Civil Procedure, s 115 (1) (ii).

327 The 1950 Code, s 268 (2), Companies Act 2005, s 849 (1).

328 The 1950 Code, s 268 (3), Companies Act 2005, s 849 (3).

329 Although there has been a debate about the scope for the types of liability which may be claimed in a derivative action, many scholars argue that such liability of a director includes all types of obligations of a director to the company. See, for example, Kenichiro Osumi and Hiroshi Imai, *Kaishahouron (Cyuukan) [the Theory of the Company Law (Volume Ii)]* (3rd edn.: Yuuhikaku, 2001), 272 ; Takeo Suzuki and Akio Takeuchi, *Kaishahou [the Company Law]* (3rd edn.: Yuuhikaku, 1994), 300. The Supreme Court recently admitted that such liability includes not only liability arising from the status as a director based on the Commercial Code, but also any obligations that have arisen from a transaction between the director and the company, such as a loan obligation. See *Ishikawa v Ishikawa* Judgment of the Supreme Court, 10 March 2009, 361 *Minshu* 63-3 (2009) (Supreme Court of Japan).

causes of action that should be the subject of the action or on the types of companies.[330] A typical type of liability claimed in a derivative action case is the liability of a director to the company for damages. When a director neglects his/her duties, he/she shall be liable to the company for the damages arising as a result thereof.[331] Any case of a director's breach of his/her duty, including duty of care and duty of loyalty, may constitute a cause for a derivative action.[332]

(5) Reimbursement to Winning Plaintiff

In cases where a plaintiff shareholder wins the action, if the shareholder is to pay a fee to an attorney, the shareholder may demand that the company reimburse him/her for a reasonable amount, not exceeding the amount of

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[330] In Singapore, a shareholder in listed companies was not granted a right to bring a derivative action before the amendment of s 216A of Companies Act in 2014. The 2014 amendment extended the statutory derivative actions to all Singapore-incorporated companies. For a comparative examination of the derivative action before the above amendment in Singapore, see Pearlie Koh Ming Choo, 'The Statutory Derivative Action in Singapore – a Critical Examination', *Bond Law Review,* 13 (2001), 64, 68.

[331] The 1950 Code, s 266 (1) v, Companies Act 2005, s 423 (1).

[332] A director must perform his/her duty with due care of a prudent manager. See Civil Code, s 644 applied mutatis mutandis to a director by the 1950 Code, s 254 (3), Companies Act 2005, s 330. Also, a director must perform her role for the company in a loyal manner in compliance with laws and regulations, articles of incorporation, and resolutions of shareholder meetings. See the 1950 Code, s 254-2, Companies Act 2005, s 355.

such fee.[333]

(6) Compensation by Losing Plaintiff

In cases where a plaintiff shareholder loses the case, the shareholder shall not be obligated to compensate the company for any litigation costs including reputational damages, except when the shareholder was acting in bad faith.[334] As for the criteria of "bad faith", it is acknowledged that the company may file a claim or counterclaim to pursue the liability of a plaintiff who inadequately brought a derivative action in the knowledge that the claim would harm the company, for example, in terms of the company's reputation. Given that it is difficult for the company to prove the plaintiff's bad faith as

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[333] The 1950 Code, s 268-2 (1), Companies Act 2005, s 852 (1). The scope of the reimbursement received by a plaintiff in a case of a win was extended to the "necessary costs (excluding court costs)", such as expenses for an investigation into a director's wrongs, in the 1993 revision. The court costs were excluded from the reimbursement which a plaintiff shareholder may demand the company to pay because the court costs are borne by a defeated party as a general civil procedure rule. See the Code of Civil Procedure s 61. Therefore, a plaintiff shareholder may demand that a defeated defendant director pay the court costs. The court costs include (i) fees for petition, for example, the filing of an action and an appeal, (ii) the travel expenses, daily allowance and accommodation charges to be incurred in order for a party to appear on the date of the oral argument or hearing or any other date designated by the court, and so forth. See the Act on Costs of Civil Procedure s 2.

[334] The 1950 Code, s 268-2 (2), Companies Act 2005, s 852 (2). See Masahiro Kitazawa, *Kaishahou [Company Law]* (6th edn.: Seirinshoin, 2001), 461.

well as the amount of the damages, even when the plaintiff loses the case, the company is unlikely to have an incentive to pursue the liability of the plaintiff. It, therefore, would be reasonable to assume that the potential for the liability for compensation would not discourage a would-be plaintiff to bring an action.

As was seen above, the prerequisite for filing a derivative action in Japan are rather formalistic. As it stands, there are no impediments to bring an action in law. The focus, now turns to the safeguard mechanisms before proceeding to examine the developments in policy and practice following the 1950 revision.

3.3.2. Safeguards Against Illegitimate or Unnecessary Actions

In order to make derivative actions work properly, effective measures should be designed to facilitate the derivative action serving the best interests of the company as well as to discourage an illegitimate or unnecessary action. Regarding the latter point, the directors should be protected against so-called "nuisance" or "strike suits."[335] However, the potential for such abusive action with an intention to harass

[335] In the US, the Supreme Court suggested that strike suits were actions brought "by people who might be interested in getting quick dollars by making charges without regard to their truth so as to coerce corporate managers to settle worthless claims in order to get rid

the defendant or to gain "quick dollars" is not a phenomenon unique to derivative actions, and rather it is not rare occurrence in ordinary civil litigation.[336] The problem inherent in derivative actions is that a self-selected plaintiff shareholder would potentially bring an action that is unnecessary in terms of the best interests of the company.

The matter of whether or not to bring an action should be decided by considering the best interests of the company. The action provides some compensation for damages and brings about the deterrent effects,[337] but at the cost of the company, such as the company's reputation, time and expense to respond and a chilling effect on the future management.[338] Therefore, a careful consideration of the dilemma is necessary in order to make a decision on the initiation of an action. Such a decision involves a commercial judgement based on an evaluation of various factors, such as risks, expenses and possible benefits, and may be considered as an "investment decision" for the company.[339] The rationale

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of them." See *Surowitz v Hilton Hotels Corp.*, 383 U.S. 363, 371 (1966) (Supreme Court of the US).

336 Tomotaka Fujita, 'Transformation of the Management Liability Regime in Japan in the Wake of the 1993 Revision', in Curtis Milhaupt, Kon-Sik Kim, and Hideki Kanda (eds.), *Transforming Corporate Governance in East Asia* (1st edn.: Routledge, 2008), 15, 22.

337 For detailed discussions on the rationale of derivative actions, see Reisberg, *Derivative Actions and Corporate Governance* , above n 9, 54-66.

338 James D. Cox, 'Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the Ali Project', *Duke Law Journal,* (1982), 959, 967-8.

339 Reisberg, *Derivative Actions and Corporate Governance* , above n 9, 50.

of granting an individual shareholder the right to make such a difficult business judgement is that the board of directors is not expected to make an unbiased decision about whether to bring an action against its current or former colleagues.[340]

However, there is no guarantee that a self-selected plaintiff (i.e., agent) always adequately and reasonably takes into consideration the interests of the company/shareholders as a whole (i.e., principal). Even if a plaintiff shareholder believes that the initiation of an action would serve the best interests of the company, the majority of shareholders may take conflicting views. The decision to bring an action is not always easy one, and a decision not to sue the directors does not necessarily indicate that the company is too lax towards its directors.[341] Given that a self-selected plaintiff will potentially bring an action whose costs would outweigh the possible benefits, mechanisms for discouraging unnecessary actions in terms of the best interests of the company are needed.[342] Many jurisdictions, therefore, implement various safeguards against worthless actions, such as the demand requirement and the special litigation committee in the US and the

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[340] If the board exclusively makes a decision to bring an action, all well and good, but it may result in less litigation than is optimal (than the intersts of the company would dictate). See Davies and Worthington, Gower's Principles of Modern Company Law , above n 153, 565.

[341] Davies and Worthington, Gower's Principles of Modern Company Law , above n 153, 568.

[342] Fujita, 'Transformation of the Management Liability Regime in Japan in the Wake of the 1993 Revision'., above n 336, 20.

judgement of the court on whether to give permission for the initiation of a derivative action.[343]

In contrast to other jurisdictions, while the safeguards against nuisance suits have been implemented in Japan, measures to assess the costs and benefits of the initiation of a derivative action in terms of the best interests of the company have not been introduced, as will be seen below.

It is worth stressing at first that the 1950 revision did not introduce a

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[343] In the US, the demand requirement, contemplated by Federal Rule 23.1, has considerable significance in practice. See Bainbridge, *Corporate Law* , above n 212, 226. It is suggested that the demand requirement is an important stage at which the court would seek a balance between the right of the board to decide to bring an action and the right of a would-be plaintiff shareholder to seek judicial review of the management's wrongdoing. See Allen, Kraakman, and Subramanian, *Commentaries and Cases on the Law of Business Organization* , above n 183, 379-380. The US court stated that a "demand is generally designed to weed out unnecessary or illegitimate shareholder derivative suits." See Barr v Wackman, 368 N.Y.S.2d 497 (1975). Furthermore, even when the demand requirement is excused, the board would establish the so-called special litigation committee to investigate the claimed transaction or event and make a recommendation to the court regarding whether or not the continuation of the action is in the best interests of the company. See Bainbridge, *Corporate Law* , above n 212, 234-238. In the UK, the Companies Act 2006 places the decision as to whether the initiation of a derivative action is in the interests of the company in the hands of the court as a gatekeeper, i.e., an outsider to the company. See Davies and Worthington, *Gower's Principles of Modern Company Law* , 598. A plaintiff must apply to the court for permission to continue a derivative claim. See The UK's Companies Act 2006, ss 261-264. For detailed discussions on the practice of these measures in the US and the UK, see Ch II above under 2.2. and 2.3.

safeguard mechanism against the abusive use of derivative actions at all.[344] Rather, the 1950 revision, by emphasising the importance of facilitating shareholder litigation, completely eliminated the article that authorised the court to order a plaintiff shareholder to provide reasonable security in shareholder litigation.

The removal of the security provision fuelled widespread fears that it would potentially cause many strike actions.[345] This raised the issue of postponing the

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[344] By contrast, the 1950 Code paid careful attention to a potential of collusive lawsuit brought by a plaintiff shareholder or the company against a defendant director. The 1950 Code, s 268 (2) provided that the company or other shareholders, in order to prevent a collusive lawsuit, may intervene in the action in a manner neither of unduly delaying the case nor of imposing unduly burden on the court facilities. Also, the 1950 Code, s 268-3 provided that the company or shareholders may enter an appeal against the final judgment by filing an action for a retrial if the plaintiff and the defendant, in conspiracy, caused the court to render a judgment for the purpose of prejudicing the rights of the subject company.

[345] Takeo Suzuki, Professor of Commercial Law at the Tokyo University, who took part in the making of the said Amendment Law as a member of the Subcommittee for the Commercial Code of the Legislative Council, provided his opinion (as of April 9, 1951) that "in Japan, in the past, most of shareholders did not exercise their right for themselves and when some of them did so, there were very many cases of abuse of right where they were offered money by a company by threatening it by pretending they would exercise their right. Accordingly, if the right of shareholders is extended as the suggestion of ESS, the extent to which it will serve the purpose of protecting the profit of shareholders in general is not clear and it is feared that it will only give a wicked shareholder a powerful weapon to compel a company to offer bribe to him." See Takeo Suzuki, 'Opinion on the Enforcement of the Amended Commercial Code as of 9 April 1951', (1951b)., printed in Nakahigashi,

enforcement of the 1950 revision. GHQ and the Government came to realise that they could not utterly ignore the insistence to postpone the enforcement rightly after the promulgation of the 1950 revision.[346] Consequently, the Commercial Code was partially amended in 1951 so that the court was authorised to order a plaintiff shareholder to provide reasonable security if a defendant director made a *prima facie* suggesting the plaintiff brought the case in "bad faith."[347]

Although the definition of "bad faith" was not discussed in detail by scholars at that time, it was acknowledged that a typical case falling under an action in "bad faith" would be a strike suit.[348] When a frivolous or harassing action has been brought, a defendant director may file a petition with the court to order a plaintiff to provide reasonable security.[349] In cases where the court orders a plaintiff to provide reasonable security, if the plaintiff fails to do so, the court must dismiss his/her action without prejudice before entering into substantive arguments. The the security provision order was expected to serve as a countermeasure by the

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Shoho Kaisei (Shouwa 25 Nen-26 Nen) Ghq/Scap Bunsho [the Revision of the Commercial Code in 1950-1951: Ghq/Scap Documents] , above n 279, 344-347.

346 Takeo Suzuki and Akio Takeuchi, *Shouhou to Tomoni Ayumu [the Path of Life with the Commercial Code]* (1st edn.: Shoujihoumu Kenkyuukai, 1977), 186-191.

347 The 1951 Code, ss 267 (4) and (5), Companies Act 2005, ss 847 (7) and (8).

348 Tadao Omori and Makoto Yazawa, 'Chushaku Kaishoho (4) [Annotation of Companies Act(4)]', (1st edn.: Yuhikaku, 1968)., 515.

349 Since the company is not made a defendant in the Japanese derivative action, the defendant director rather than the company may file such petition.

defendant directors against strike suits.[350]

While the 1951 revision incorporated the security provision order, no other screening mechanism was introduced. In particular, there has been no mechanism for considering the company's voice as to whether bringing an action is in the best interests of shareholders as a whole.

Interestingly, a close examination of the process of the 1950 revision shows that a proposal to implement such mechanism was presented at the deliberation on the 1950 revision. The Economic and Scientific Section of GHQ ("ESS") proposed a draft of an article as follows:

> In the case of a suit filed in accordance with the previous article, the court, before proceeding with the suit, shall first determine whether the representatives do fairly represent any other shareholders and whether the interests of the representatives are substantially identical with the interests of the other shareholders represented. Unless the court so determines, the

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[350] Takeo Suzuki (for an introduction of his backgrounds, see above n 345) provided his supplementary opinion (as of April 25, 1951) that if the court was aushorised, on the defendant's *prima facie* evidence showing that the plaintiff shareholder brought an action in bad faith, to order the plaintiff to provide reasonable bond, the prevention of the abuse by "wicked shareholders" may well be achieved. See Takeo Suzuki, 'Supplement to My Opinion on the Enforcement of the Amended Commercial Code as of 25 April 1951', (1951a)., printed in Nakahigashi, *Shoho Kaisei (Shouwa 25 Nen-26 Nen) Ghq/Scap Bunsho [the Revision of the Commercial Code in 1950-1951: Ghq/Scap Documents]* , above n 279, 348.

> suit shall be considered and adjudged as one brought only on behalf of the persons named.[351]

This proposed article was expected to provide for judicial review on whether the initiation of an action serves the best interests of the company. However, the proposal was rejected by the Japanese government. The memorandum for the record, Steiner, Legislation and Justice Division, Revision of the Commercial Code, June 27, 1949, explains as follows:

> The original draft by ESS gave the shareholders right to sue a director in a representative capacity for "all shareholders similarly situated" and consequently provided for a preliminary determination of 'true representation' by the court. The Japanese side contended at first that public notice of all such suits is necessary for the benefit of the other shareholders who may want to join or to disassociate themselves from the action. However, such public notice appeared potentially harmful to the company and the proposal was finally discarded.[352]

It seems unreasonable to reject the proposal on the grounds that the public notice to

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[351] See a corrected draft for the revision of the Commercial Code regarding derivative actions as of 4 May 1949, printed in Nakahigashi, *Shoho Kaisei (Shouwa 25 Nen-26 Nen) Ghq/Scap Bunsho [the Revision of the Commercial Code in 1950-1951: Ghq/Scap Documents]* , above n 279, 75.

[352] See Steiner (Legislation and Justice Division of Ghq/Scap), 'Memorandum for the Record on the Subject of Revision of the Commercial Code as of 27 June 1949'., above n 312, 136.

notify the other shareholders of the initiation of the action would potentially harm the interests of the company. Even assuming that such notice would potentially damage the company's reputation, there was no need to reject entirely the proposal of introducing judicial review on the merits of the action. This episode suggests that the unique problem of derivative actions that a self-selected plaintiff shareholder may bring an unnecessary or worthless action was not fully acknowledged then in Japan.

In this context, it should be also noted that the company cannot express its voice on the merits of the action in terms of the best interests of shareholders as a whole. As described above, the company is not made a defendant to the claim or is automatically involved in a derivative action in Japan. While the company may intervene as a "co-party" of a plaintiff shareholder in order to prevent the plaintiff from proceeding with an action in collusion with a defendant director, it was unclear whether and when the company may intervene in a derivative action as a "supporting intervener" in order to assist a defendant director before the 2005 revision explicitly authorised such intervention.[353] Furthermore, even after the 2005 revision, it is still unclear whether the company is able to claim that an action, which has been brought by a shareholder with seemingly sufficient evidence suggesting a defendant director's breach of duties, would damage the interests of

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[353] Companies Act 2005, s 849 (2) stipulates the conditions and procedures for the company to intervene in a derivative action to assist a defendant director.

the company.[354] Even if the company makes such claim while intervening in a derivative action to assist a defendant director, the court is not authorised to dismiss the action by reason of the fact that the action is contrary to the interests of the company.[355]

To sum up, the 1950 revision incorporated the easily accessible derivative action without measures for sorting out the agency problem between the self-selected plaintiff shareholders and the company. There is no opportunity to hear the company's voice as to whether a derivative action is in the best interests of the shareholders as a whole.

Given that the 1950 Code was drafted by the Japanese government in close consultation with GHQ/SCAP, it would be reasonable to assume that the approach described above was adopted under a significant influence of the then debate with regard to derivative actions in the US. While the potential for abuse was widely recognised and some states in the US incorporated safeguards to prevent abuse,[356]

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354 Fujita, 'Kabunushi Daihyou Soshou No Gendaiteki Tenkai [the Modern Development of Derivative Actions]'., above n 92, 47-9.

355 Ibid.

356 Ballantine, 'Abuses of Shareholders Derivative Suits: How Far Is California's New "Security for Expenses" Act Sound Regulation?', above n 62, 400. At the outset, the New York Security-for-Expenses Act under Section 61b, General Corporation Law, introduced a scheme for requiring the plaintiff having less than five per cent of the outstanding shares, unless her holdings had a market value in excess of USD 50,000, to give security for the costs and expenses of the defendants in 1944. This legislation was followed by New Jersey, Pennsylvania, Wisconsin, and California.

there was a prevailing view in favour of derivative actions in the 1940's in the US. Such view was well expressed by Mr. Justice Jackson in a Supreme Court decision in 1949, describing the shareholder's derivative actions as "the chief regulator of corporate management."[357] It was 1970's that the special litigation committee emerged in response to a dramatic increase in derivative actions in the US.[358]

While the Japanese derivative action has seen several procedural and substantive amendments since 1950, all of the basic characteristics have, in principle, remained intact.[359] The focus, now will be turned to the examination of

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[357] *Cohen v Beneficial Indus. Loan Corp.*, 337 US 541, 548 (1949) (Supreme Court of the US).

[358] Bainbridge, *Corporate Law* Stephen Bainbridge, above n 212, 234.

[359] For a development in provisions regarding procedures of the derivative action before the 2014 Revision of Companies Act, see Appendix. As Appendix shows, articles regarding derivative actions have seen several revisions since the introduction in the 1950 revision. The first revision was to incorporate the system of a security bond provided by a plaintiff shareholder in the 1951 revision. The second was to confirm a small and fixed amount of a litigation fee paid by a plaintiff to file an action in the 1993 revision. The third was to clarify a procedure for effecting a settlement in a derivative action case and to make some technical procedural amendments in the 2002 revisions (two revisions in April and May in 2002). The last was to incorporate an article providing that the court must dismiss the case in cases where the purpose of an action is to seek unlawful gains of a plaintiff shareholder or a third party or to inflict damages on the company in the 2005 revision. See Companies Act 2005, proviso to s 847 (1). However, it is acknowledged that this provision did not implement a new safeguard but just confirmed that a general civil procedure rule, preventing abuse of civil actions, was applied to derivative actions in an adjusted way for

the developments since the 1950 revision.[360]

3.4. Removal of the Practical Impediment in the 1993 Revision

3.4.1. Scant Use of Derivative Actions Before 1993

Contrary to the fear of the business community,[361] the substantially accessible

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its structure. See Tetsu Aizawa, *Ichimom Ittou-Shin Kaishahou [Questions and Answers About New Company Law]* (2nd edn.: Shoji-houmu, 2009), 243-246. For the 2014 Revision of the Companies Act, see Saburo Sakamoto, *Ichimom Ittou-Heisei 26nen Kaisei Kaishahou [Questions and Answers About the 2014 Revision of Companies Act]* (2nd edn.: Shoji-houmu, 2015).

[360] As explained under 3.3.1., the plaintiff may demand that the company reimburse him/her for necessary costs, such as a reasonable amount of fee to an attorney and expenses for an investigation, only if the plaintiff wins the action. The Japanese rule is different from the Wallersteiner rule in that the plaintiff may not demand the reimbursement if he/her fails the action.

[361] For example, Teizou Horikoshi, Managing Director of Keidanren (Japan Business Federation) expressed an opinion, as a voluntary testifier at the meeting of the Committee on Judicial Affairs in the House of Representatives held on 14 April 1950, that a shareholder acting in bad faith brining a derivative action would potentially make directors terribly busy with response to derivative actions. See Japan's House of Representatives, 'No.28 of Minutes of the Committee on Judicial Affairs in the House of Representatives of the 7th Diet' (1950) <http://kokkai.ndl.go.jp/SENTAKU/syugiin/007/0488/00704140488028.pdf> accessed 8 January 2016.

derivative action without a safeguard mechanism for sorting out the agency problem between the self-selected plaintiff shareholders and the company in law had not been a concern for management in practice for a long time. The derivative action was scarcely brought after the introduction in the 1950 revision. It was not until six years later that the first case of derivative actions was brought.[362] It is reported that there were only 10 derivative actions filed between 1950 and 1989.[363] In fact, fewer than 20 derivative actions were brought during the 40 years from 1950 to 1990.[364]

It is now widely recognised that the primary reason for the scant use of derivative actions for a long time after the introduction in Japan was the court

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362 *Huang v Li*, 19 October 1956, 7 Kaminshu 2934 (1956) (Tokyo District Court of Japan).

363 [Counselor's Office of the Civil Affairs Bureau-Ministry of Justice] Houmushou Minjikyoku Sanjikanshitsu, *Ichimon Ittou Heisei Gonen Kaisei-Shouhou [Questions and Answers About the 1993 Revision of the Commercial Code]* (1st edn.: Shouji-houmu Kenkyuukai, 1993), 19. Shinsaku Iwahara, 'Kabunushi Daihyou Soshou No Kouzou to Kaisha No Hikoku Gawa Heno Soshou-Sanka [the Structure of the Derivative Action and the Company's Intervention to Assist the Defendant', in Akio Takeuchi (ed.), *Tokubetsu Kougi Shouhou I [the Special Lecture of the Commercial Code I]* (Yuuhikaku, 1995) 225, 226.

364 West, 'The Pricing of Shareholder Derivative Actions in Japan and the United-States', above n 43, 1438. West did not provide any evidence or source for those statistics.

practice regarding the litigation fee.[365] A plaintiff has to pay the litigation fee so as to file an action under the Japanese civil action system.[366] The amount of the fee is, in principle, obtained by making a calculation based on a sliding scale according to "the value of the subject matter of the action."[367] Therefore, for instance, if the value of the subject matter of the action is JPY one billion (around GBP 5,800,000

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[365] West, 'Why Shareholders Sue: The Evidence from Japan', above n 43, 355. See also Fujita, 'Transformation of the Management Liability Regime in Japan in the Wake of the 1993 Revision'., above n 336, 16.

[366] The Act on Costs of Civil Procedure s 3.

[367] Appended Table 1 of Act on Costs of Civil Procedure specifies how to calculate the amount of the fee according to the value of the subject matter of the action. The Table 1 as of 1993 is as follows:

(i) The portion up to JPY 300,000 of the value of the subject matter of the action: JPY 500 per JPY 50,000 of such portion of the value (up to JPY 300,000: 1 %)
(ii) The portion of the value of the subject matter of the action in excess of JPY 300,000, up to JPY one million: JPY 400 per JPY 50,000 of such portion of the value (from JPY 300,000 to JPY 1,000,000: 0.8%)
(iii) The portion of the value of the subject matter of the action in excess of JPY one million yen, up to JPY three million: JPY 700 per JPY 100,000 of such portion of the value (from JPY 1,000,000 to JPY 3,000,000: 0.7%)
(iv) The portion of the value of the subject matter of the action in excess of JPY three million, up to JPY ten million: JPY 1,000 per JPY 200,000 of such portion of the value (from JPY 3,000,000 to JPY 10,000,000: 0.5%)
(v) The portion of the value of the subject matter of the action in excess of JPY ten million, up to JPY one hundred million: JPY 1,000 per JPY 250,000 of such portion of the value (from JPY 10,000,000 to 100,000,000: 0.4%)
(vi) The portion of the value of the subject matter of the action in excess of JPY one hundred million, up to JPY one billion: JPY 3,000 per JPY 1,000,000 of such portion of the value (from JPY 100,000,000 to 1,000,000,000: 0.3%)
(vii) The portion of the value of the subject matter of the action in excess of JPY one billion: JPY 10,000 per JPY 5,000,000 of such portion of the value (from JPY 1,000,000,000: 0.2%)

Although the above Appended Table 1 has been revised since 1993, the basic concept of the sliding scale calculation based on the value of the subject matter of the action has not changed.

as of 8 January 2016), a plaintiff is required to pay about JPY 3,000,000 (around GBP 18,000 as of 8 January 2016) as of today. On the other hand, with regard to an action bringing a claim that is not on a property right,[368] the value of the subject matter of the action shall be deemed to be JPY 950,000 (around GBP 5,600 as of 8 January 2016) as of 1993 (JPY 1,600,000 as of today).[369] This calculation is the case in an action bringing a claim on a property right for which it is extremely difficult to calculate the value of the subject matter of the action.[370] In such cases, the amount of the litigation fee was JPY 8,200 (around GBP 50 as of 8 January 2016) (JPY 13,000 or around GBP 75 as of 8 January 2016) by calculation based on the fundamental rule.[371]

The issue here focused on what is to be regarded as the value of the subject matter of the action in derivative actions. There were two possible views that could be adopted by the court. The first one was to regard the amount of a defendant

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[368] An action bringing a claim on a property right means an action to claim rights or legal relations related to economic interests. Mikio Akiyama et al., *Konmentaru Minjisoshohou I [the Commentary of the Code of Civil Procedure I]* (2nd, supplemented edn.: Nihonhyoronsha, 2014), 107. On the hand, an action bringing a claim that is not on a proper right includes an action to claim personal rights and an action to claim rights related to kinship. See Makoto Ito, *Minjisoshohou [Civil Procedure]* (4th, supplemented edn.: Yuhikaku, 2014), 69.

[369] The Act on Costs of Civil Procedure, s 3 (2).

[370] The Act on Costs of Civil Procedure, s 3 (2).

[371] The fixed amount of JPY 8,200 was worked out based on the calculation described above: JPY 300,000*1%+ (JPY950,000 - JPY300,000)*0.8%=JPY8,200.

director's liabilities to the company claimed by a plaintiff as the value of the subject matter of the derivative actions.[372] However, in this view, the cost, i.e., the litigation fee, would not be proportionate to the benefits for the plaintiff. It is not the plaintiff shareholder but rather the company who receives compensation for damages by a defendant director when the plaintiff wins the case. The plaintiff shareholder would gain only a pro rata benefit, and then be only indirectly rewarded.[373] The second view started from this point, and then argued that the value of the subject matter of the derivative actions should be denoted by the economic benefits that the shareholders as a whole would receive in a win.[374] This further implied that the economic benefits of the shareholders as a whole were not necessarily the same as the amount of the compensation by a defendant director and, therefore, were extremely difficult to calculate. Thus, this view concluded that the value of the subject matter of the derivative actions, i.e., the benefits of the shareholders as a whole, was JPY 950,000,[375] and the amount of the litigation fee was JPY 8,200.

Of these two possible ways, while the court practice was divided, the first view seemed predominant before 1993. This means a plaintiff shareholder was

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[372] Akira Kawatani, 'Minjisoshou-You-Inshi No Kenkyu [the Studies in the Litigation Fee]', *Shokikan Jitsumu Kenkyu [The Studies in Practice of Court Clerk],* 1 (1963), 78.

[373] Akio Takeuchi, 'Torishimariyaku No Sekinin to Daihyousoshou [the Director's Liability and Derivative Actions]', *Hogaku-Kyoshitsu,* 99 (1988), 6.

[374] Ibid.

[375] The Act on Costs of Civil Procedure, s 3 (2).

required to bear the heavy burden of the litigation fee when he/she intended to bring a derivative action claiming a large sum of a director's liabilities.[376] For example, in the Mitsui Mining case,[377] a plaintiff shareholder brought a derivative action against the directors of the Mitsui Mining Company claiming that the defendant directors had liabilities of JPY 3,551,600,000 (around GBP 20.8 million as of 8 January 2016). However, in that case, the amount of compensation, which the plaintiff shareholder actually demanded that the defendant directors should pay to the company, was only JPY 100,000,000 (around GBP 587,000 as of 8 January 2016) rather than JPY 3,551,600,000. The Tokyo District Court rendered a decision ordering the defendant directors to pay JPY 100,000,000 to the company while the court confirmed the total amount of the directors' liabilities was JPY 3,551,600,000 as a matter of fact. It would be possible to assume that the plaintiff limited the amount of the compensation, which he demanded, to JPY 100,000,000 so as to

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[376] When a shareholder intended to bring a derivative action claiming that a defendant director has liabilities of JPY one hundred million (around GBP 580,000 as of 8 January 2016), the litigation cost as of 1993 was JPY 417,600 (around GBP 2,400 as of 8 January 2016) (JPY 300,000*1% + JPY 700,000*0.8% + JPY 2,000,000*0.7% + JPY 7,000,000*0.5% + JPY 90,000,000*0.4% = JPY 417,600). Suppose she claimed a director's liabilities of JPY one billion, the fee was JPY 3,117,600 (around GBP 18,000 as of 8 January 2016) (JPY 417,600 + JPY 900,000,000*0.3% = JPY 3,117,600).

[377] *Mizuno v Ariyoshi*, Tokyo District Court, 1194 Hanrei Jihou 33 (1986), Tokyo High Court, 826 Kinyu Shoji Hanrei 3 (1988), Supreme Court, vol.47 no.7 Saikou Saibansho Minji Hanreishu 4814 (1993) (Tokyo District Court, Tokyo High Court and Supreme Court of Japan).

save the litigation fee. Indeed, the plaintiff paid the fee of JPY 502,900 (around GBP 2,900 as of 8 January 2016) for the claim of JPY 100,000,000,[378] which was calculated according to the first view regarding the value of the subject matter in a derivative action. If the shareholder had brought such action demanding that the directors pay the compensation of JPY 3,551,600,000, he/she would have been required to pay the fee of around JPY 17,800,000 (around GBP 104,700 as of 8 January 2016) according to the first view.

The massive disincentive of this court practice on a possible plaintiff was well illustrated by another example of a decision of the Tokyo District Court in the 1992 Nikko Securities case.[379] In this case, two individual shareholders brought a derivative action claiming liabilities of around JPY 47 billion (around GBP 270 million as of 8 January 2016) against sixteen directors, alleging that the company had illegally made compensation for losses of an important fraction of its customers. The Tokyo District Court adopted the first interpretation that the litigation fee shall be calculated assuming the value of the subject matter of the action was the amount of claimed liabilities, and then ordered the plaintiff shareholders to pay JPY 235,374,400 (around GBP 1.4 million as of 8 January 2016) as the litigation fee. Since the plaintiff shareholders did not pay the fee, the

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[378] See a complaint for that case reported in 27 Shiryouban Shoji Houmu 46 (1986).

[379] *Asai v Iwasaki*, Tokyo District Court, 797 Hanrei Times 382 (1992), rev'd, Tokyo High Court, 823 Hanrei Times 131(1993) (Tokyo District Court and Tokyo High Court of Japan).

Tokyo District Court dismissed the action. It is difficult to imagine that any individual shareholder would be able and willing to pay such an enormous sum of litigation fee.

In the Nikko Securities case, the plaintiff shareholders appealed the decision of the district court. The Tokyo High Court, in March 1993, revoked the judgement of the district court, deciding instead that the value of the subject matter of a derivative action shall be regarded as the benefits of the shareholders as a whole from a win, and that the value should be deemed to be JPY 950,000 rather than the amount of the claimed liabilities for damages (in that case, around JPY 47 billion) since such benefits were extremely difficult to calculate.[380]

The Nikko Securities decision came as the Commercial Code was due for a partial amendment. The revised Code was proclaimed on 14 June 1993. The 1993 Revision, so as to confirm the above interpretation of the Tokyo High Court in the Nikko Securities case, added an article to the effect that a derivative action shall be deemed to be an action relating to a claim which is not a claim based on a property right in calculating the value of the subject matter of the action.[381] This means a

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[380] The Tokyo High Court adopted an interpretation that the litigation fee for the derivative action was fixed at 8,200 yen. The Tokyo High Court suggested that a derivative action was litigation for non-property claims and calculated the litigation fee based on that idea. See *Asai v Iwaasaki et al.*, Tokyo High Court, 30 March 1993, 46 Kosai-Minshu [High Court Reporter] 20 (1993) (Tokyo High Court of Japan). For details, see Tomotaka Fujita, above n 336, 16.

[381] The 1993 Code, s 267 (4), Companies Act 2005, s 847 (6).

shareholder was able to bring a derivative action by paying just JPY 8,200 (around GBP 50 as of 8 January 2016) (JPY 13,000 or around GBP 75 as of 8 January 2016). The serious practical barrier regarding the litigation fee was removed in this way. What followed was unsurprising.

3.4.2. Dramatic Increase of Derivative Actions After 1993 and Defendant's Response

A sea change was seen immediately after the 1993 Revision removed the practical obstacle of the litigation fee. The number of derivative actions filed dramatically increased. The number of derivative actions newly filed each year at district courts at the end of each year is reported as follows:[382]

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[382] The statistics for the period from 1950-1989 to 1992 are reported in Houmushou Minjikyoku Sanjikanshitsu, *Ichimon Ittou Heisei Gonen Kaisei-Shouhou [Questions and Answers About the 1993 Revision of the Commercial Code]* , above n 363, 19. Those for the period from 1993 to 2010 are reported in Fukui, 'Kaishahou Sekougono Kabunushi-Daihyou-Soshou No Gaikyou [the General Report on Derivative Actions after the Enforcement of the Companies Act]', above n 276, 72. As can be seen, the statistics of derivative actions newly filed in 1993, 1994 and 1995, and pending at the end of the years 1950-1989, 1990 and 1991 are not reported. For statistics of the Tokyo District Court, see Koichi Yoshida, 'Tokyo-Chisai Ni Okeru Shouji-Jiken No Gaikyo [Overviews on Commercial Litigation in the Tokyo District Court]', *Junkan Shoujihoumu,* 2141 (2017), 34-50.

Table 1: Number of Newly Filed Derivative Action Cases in All District Courts in Japan and the Tokyo District Court

Year	*All*	*Tokyo*	*Year*	*All*	*Tokyo*
1950 - 1989	10				
1990	4		2004	78	29
1991	5		2005	70	24
1992	12	5	2006	72	25
1993	-	18	2007	70	29
1994	-	35	2008	64	17
1995	-	22	2009	70	20
1996	68	16	2010	78	27
1997	88	36	2011	83	18
1998	73	22	2012	106	37
1999	95	30	2013	98	26
2000	84	17	2014	58	16
2001	66	17	2015	59	12
2002	78	20	2016	36	11
2003	85	20	2017	37	-
			Total	1648	549
			Mean	75.2	22.3

Note: The mean of number of newly filed derivative action cases in all district court and the Tokyo district cours shows the average case numbers for the period between 1996 and 2016.

The considerable increase in the number of derivative actions naturally caused a rise in the number of petitions by a defendant for the court order for the provision of security by a plaintiff. As described above, the 1951 revision introduced the provision to the effect that the court may order a plaintiff shareholder to provide reasonable security provided that a defendant files a petition with *prima facie* evidence showing that the action filed by the plaintiff is in "bad

faith."[383]

Since both a derivative action and a petition for a court order to provide security were rare, the definition of the "bad faith" was unclear before 1993. However, in the immediate aftermath of the large increase in the number of derivative actions as well as petitions for the security provision order, many decisions regarding the criteria for "bad faith" were published. Among them, the ruling of the Tokyo District Court in the Janome Sewing Machine case in 1994 established the dominant interpretation. The Tokyo District Court decided that the court shall order the security provision if (1) the plaintiff filed a derivative action notwithstanding the acknowledgment that the claim would most likely be dismissed by the court, or that (2) the plaintiff brought the claim for the purpose of obtaining an unlawful gain by abusing the derivative action claim.[384] The first of these two criteria has been more important in court practices. The majority of the court orders to require a plaintiff to provide security have depended on the first criterion.[385] This first criterion was derived from the general civil rule in Japan that malevolent litigation, which was intentionally or negligently brought

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[383] The 1951 Code, ss 267 (5) and (6), Companies Act 2005, ss 847 (7) and (8).

[384] *Morita v Unidentified*, Tokyo District Court, 22 July 1994, 1504 Hanrei Jiho 121 (1994) (Tokyo District Court of Japan).

[385] Tomotaka Fujita, 'Kabunushi-Daihyo Sosho No Teiki Ga Akui Ni Idetamonotoshite Tanpoteikyo-Ga Meijirareta Jirei [the Case Where the Court Orders a Plaintiff to Provide Security on the Grounds That a Shareholder's Derivative Action Was Filed in Bad Faith]', *Jurist,* 1144 (1998), 117, 118.

notwithstanding the lack of factual or legal grounds, constitutes a tort to the defendant.[386] The Tokyo District Court in the Janome case explained that the security was held primarily as security for the defendant's claim against the plaintiff. This rationale well illustrated the point that the court order for a plaintiff to provide security was viewed as a protective mechanism for a defendant director.

Indeed, it seems that the authority of the court to order a plaintiff to provide security has blocked the bulk of frivolous or meritless litigation. It was reported that there were over 40 published judgements in response to a defendant's petition for the security provision order just within three years after the 1993 Revision.[387] It was also said in those days that the defendant seemed to have a great likelihood of winning the court order for the plaintiff to provide security for a large sum in a relatively short time from the date of filing a petition, and that the court order to provide security functioned as an effective safeguard for defendants against nuisance actions.[388] Although empirical studies would be required, preliminarily it can be expected that abusive derivative actions, for example, frivolous or harassing claims, have effectively been discouraged by the court in order to provide security.

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386 *Hirohara v Nagano*, Supreme Court, 26 January 1988, 42 Saihan Minshu [Supreme Court Reporter (Civil)] 1 (1988) (Supreme Court of Japan).

387 Fujita, 'Kabunushi-Daihyo Sosho No Teiki Ga Akui Ni Idetamonotoshite Tanpoteikyo-Ga Meijirareta Jirei [the Case Where the Court Orders a Plaintiff to Provide Security on the Grounds That a Shareholder's Derivative Action Was Filed in Bad Faith]', above n 385, 118.

388 Ibid.

In the US, it is suggested that would-be plaintiffs are, in practice, frequently disqualified under the fairness and adequacy requirement where they filed the action for strategic purposes relating to other disputes with the company or its management.[389] In this sense, the court order to provide security in Japan can be regarded as fulfilling functions partly identical to the requirement of the fair and adequate representation in the US.

3.5. Initial Assessment of the Derivative Action in Japan

3.5.1 Absence of Safeguards Against Unnecessary Actions

As described above, the order to provide security has discouraged the abusive use of derivative actions to some extent.[390] However, Japan has not implemented, in law, an additional screening mechanism against unnecessary actions whose costs may outweigh the possible benefits in terms of the interests of the shareholders as a whole even after seeing the dramatic increase of derivative actions. The important question, then, is whether companies in Japan have suffered from this type of

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[389] Bainbridge, *Corporate Law* , above n 212, 222.

[390] [the Study Group of the Derivative Action] Kabunushi Daihyo Sosho Seido Kenkyu-Kai, 'Kabunushi Daihyo Sosho Ni Kansuru Jimintou No Shouhou-Tou Kaisei-Shian Kosshi Ni Taisuru Iken [Opinions on the Main Points of the Draft for the Revision of the Commercial Code, Etc. Proposed by the Liberal Democratic Party]'', *Junkan Shoujihoumu,* 1471 (1997), 2, 9.

unnecessary derivative action. Interestingly, it is argued that the court, in practice, has appeared to consider the interests of the company in response to a defendant director's petition for a court order to provide security although the security order is, in theory, regarded as a security to protect the interests of a defendant director rather than the company.[391] Put differently, the court order for security provision, which is, in principle, for the protection from strike suits, has possibly worked as a substitute for the mechanism to deal with the unnecessary or worthless actions.[392]

However, it must be taken into account that there remains a significant gap not filled by that substitute. The court order to provide security is primarily regarded as a protective shield for the defendant from frivolous or harassing litigation in Japan. It is, by nature, not a screening mechanism to consider the agency problem between an individual plaintiff owning only a small proportion of shares and the shareholders as a whole. The court order, therefore, faces an unavoidable limitation in practice. In particular, suppose that a shareholder plaintiff brings a derivative action with seemingly sufficient evidence and legal grounds while the action would be harmful to the interests of the shareholders as a whole considering the litigation costs, the negative reputational effect on the company and

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[391] Fujita, 'Kabunushi-Daihyo Sosho No Teiki Ga Akui Ni Idetamonotoshite Tanpoteikyo-Ga Meijirareta Jirei [the Case Where the Court Orders a Plaintiff to Provide Security on the Grounds That a Shareholder's Derivative Action Was Filed in Bad Faith]', above n 385, 119.

[392] Fujita, 'Transformation of the Management Liability Regime in Japan in the Wake of the 1993 Revision'., above n 336, 21.

so forth. In such a case, the court cannot order the plaintiff to provide security. This is because the security is not a measure for sorting out the agency problem described above. The security is provided by the plaintiff just for a defendant's tort claim against the plaintiff bringing an action without adequate evidence and legal grounds. If the plaintiff seems to bring an action with sufficient evidence and legal grounds, the defendant cannot bring a tort claim against the directors and the court cannot order the security provision. It, thus, can be concluded that the regime of Japanese derivative actions lacks the mechanism to straightforwardly consider the interests of the shareholders as a whole. In fact, it is suggested that the nature of the problem of possibly worthless derivative actions was not well understood until recently.[393]

It should be noted here that there was a possibility to introduce a screening mechanism in order to directly take into account the interests of the shareholders as a whole in the 2005 Revision.[394] A bill of the 2005 revision initially included a proposed provision stipulating that a shareholder cannot bring a derivative action in cases where it is, with reasonable certainty, expected that the action would cause

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[393] Ibid, 20.

[394] The Japanese Commercial Code experienced a "de-codification" in 2005. The Book II of the previous Commercial Code contained provisions regarding the company. These provisions were deleted from the Code in the 2005 revision. The provisions concerning the company are now provided by the Companies Act 2005 (Law No.86, 2005). For a brief explanation of the background of the 2005 revision, see Fujita, '"De-Codification" of the Commercial Code in Japan', above n 278, 3.

considerable damage to the justifiable interests of the company, or that the action would have the company suffer excessive cost, or the like.[395] This proposed provision was intended to enable the court to directly consider the interests and costs of the company. The proposed new limitation on derivative actions could have introduced a screening mechanism to deal with the issue of the agency problem between a shareholder plaintiff and the shareholders as a whole to some extent. It is, then, argued that this proposed provision can be regarded as the Japanese version of the "fair and adequate" representation requirement for the shareholder plaintiffs in derivative actions.[396]

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395 The proposed draft of Companies Act 2005, s 847(1). In addition to the proposed provision, the 2005 revision actually added a provision specifying that a shareholder is not allowed to bring a derivative action in cases where the purpose of the action is to seek unlawful gains for the plaintiff or a third party or to inflict damages on the company. See Companies Act 2005, s 847(1). This new provision did not incorporate a new rule into derivative actions. Rather, it just confirmed that the general limitation for the misuse of civil actions is applied to derivative actions as well. Although there was not such a provision before the 2005 revision, it was interpreted that the action brought for the purpose of seeking unlawful gains or of inflicting damages on the company would be dismissed. See *Kono v Yoneda*, Nagasaki District Court, 19 February 1991, 1393 Hanrei Jiho 138 (1991) (Nagasaki District Court of Japan).

396 Fujita, 'Transformation of the Management Liability Regime in Japan in the Wake of the 1993 Revision'., above n 336, 22. Considering the suggestion of the court in the US that the demand requirement "is generally designed to weed out unnecessary or illegitimate shareholder derivative suits" in *Barr v Wackman*, 368 N.Y.S.2d 497 (1975), it seems reasonable to say that the proposed provision in the 2005 revision can be regarded as a

The proposal to introduce the new limitation on derivative actions, however, attracted harsh criticism during the discussion in the House of Representatives and consequently was deleted from the bill for the 2005 revision. Opponents insisted that the criteria for the prohibition of derivative actions were unclear and that the new limitations would potentially decrease the function of derivative actions.[397] Although it is noteworthy that the need to discourage worthless derivative actions was recognised in the discussion of the Legislative Council of the Ministry of Justice, the proposal was not adopted in the 2005 revision for political reasons in the end.[398] As a result, the derivative action in Japan still lacks a screening mechanism to consider the interests of the shareholders as a whole.

3.5.2. Incentive Problem and Potential for Under-Enforcement

If it were assumed that many companies, indeed, suffer from unnecessary derivative actions in Japan, the urgent demand for safeguards against such actions would be presented.[399] However, as described above, the proposal to introduce the

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mechanism fulfilling a function identical to the demand requirement in the US in that they protect the interests of the company from unnecessary actions.

[397] Aizawa, *Ichimom Ittou-Shin Kaishahou [Questions and Answers About New Company Law]* , above n 359, 245.

[398] Fujita, 'Transformation of the Management Liability Regime in Japan in the Wake of the 1993 Revision'., above n 336, 22.

[399] It is interesting to compare the development of derivative actions in Japan with that in the US. While derivative actions were valued until 1960's, the Supreme Court sharply

mechanism to consider whether the initiation of a derivative action is in the interests of the company was rejected in the 2005 revision. This episode illustrates that the need of safeguards to protect the interests of the company in a derivative action was not widely perceived in Japan.

The question is, then, why such need seemingly has not been recognised well. Several possible explanations exist. Firstly, substantive rules, especially the Japanese version of a business judgement rule rather than procedural rules, would have served as a screening mechanism to weed out unnecessary derivative actions. There have been a number of judgements confirming that the directors have considerable discretion in making decisions on business issues.[400] Many courts

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reversed the direction during the 1970's in the US. It is argued that multiple factors, such as the shift toward "independent" boards of directors, the belief of market remedies, the dependence on public enforcement agencies, the caseload pressure on courts, and especially the judicial doubt about the function of derivative actions, may have forced courts to change their attitudes. See Coffee, 'The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation', above n 30. In particular, it seems possible to infer that since the US courts saw many derivative actions, in which a plaintiff failed to win and which caused the shareholders as a whole bear the costs in excess of the benefits, they reached a skeptical assessment of derivative action. The so-called special litigation committee was introduced and has been widely used since the 1970's. See Bainbridge, *Corporate Law* , above n 212, 234. For detailed discussions, see Ch II above under 2.1.

[400] See, for example, *Hongo v Matsushita*, Osaka District Court, 16 May 1999, 1710 Hanrei Jiho 153 (1999) (Osaka District Court of Japan), confirming broad discretion of directors as to business issues, and then stating that directors' decisions on business issues would not be beyond the scope of their discretion and therefore would not constitute a

referred explicitly to the business judgment rule and suggested the limited scope of their review of management's decision before they examined the particular cases.[401] This court practice may have relatively allayed the directors' fear of being exposed to unnecessary derivative actions. This explanation will be discussed later in Chapter IV and V. Secondly, it may have been implicitly acknowledged that the derivative action should be facilitated in Japan since there is no effective alternative for shareholders with limited corporate governance tools to make directors accountable, such as independent directors, market remedies and so forth.[402] Finally, taking into account the problem of the lack of an incentive for a plaintiff and its attorney, it seems plausible to assume that even after the 1993 Revision removed the practical impediment of the litigation fee, shareholders do not bring a derivative action frequently in Japan. Indeed it is pointed out that derivative actions seem to be taken infrequently especially for listed companies.[403] If this holds true, notwithstanding the lack of safeguards, the agency problem

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breach of duties of care or duty of loyalty not only if there is not a critical and careless misunderstanding of the facts based on which the decisions were made but also if the process and substance of the decision making is not extremely unreasonable and inadequate for the management.

[401] Fujita, 'Transformation of the Management Liability Regime in Japan in the Wake of the 1993 Revision'., above n 336, 29.

[402] For discussions on the role of derivative actions in the context of corporate governance matrix, see Ch I above under 1.3.

[403] Fukui, 'Kaishahou Sekougono Kabunushi-Daihyou-Soshou No Gaikyou [the General Report on Derivative Actions after the Enforcement of the Companies Act]', above n 276.

between a self-selected plaintiff and the company has not been acute in Japan. The remaining part of this section will discuss the potential for the under-enforcement of derivative actions due to the incentive problem for a plaintiff and its attorney in Japan.

It is widely recognised that a plaintiff shareholder gains little benefits even when he/she wins in a derivative action.[404] On the other hand, as it is suggested that the principal beneficiaries of the shareholder litigation appear to be attorneys in the US.[405] Attorneys may have a great incentive to find a nominal shareholder and to encourage him/her to bring a derivative action. However, whether the attorneys are willing to invest their time and effort to do so would depend on the costs and the fees for them in derivative actions.[406] In Japan, a plaintiff who wins in a derivative action may demand that the company reimburse a reasonable amount of the attorneys' fee.[407] Thus, it can be expected, at first glance, that the reimbursement of the attorneys' fee by the company would make derivative actions profitable business for the attorneys. An examination of the court practice, however, indicates that the attorneys cannot necessarily achieve attractive returns on their

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[404] Even if the action is successful, any damages recovered accrue to the company and the plaintiff shareholder will receive only a pro rata share of the gains. See Reisberg, *Derivative Actions and Corporate Governance* , above n 9, 222.

[405] Romano, 'The Shareholder Suit: Litigation without Foundation?', above n 30, 84.

[406] For detailed discussions, see Reisberg, *Derivative Actions and Corporate Governance* , above n 9, Ch 6.

[407] The 1950 revision s 268-2 (1), Companies Act 2005, s 852 (1).

investment in derivative actions as explained below.

Before proceeding to examine the reimbursement in derivative actions, it is worth introducing the common practice with respect to an attorney's fee agreement in general civil cases.[408] The Attorney Act (Act No. 205 of 1949) had provided that the Japanese Federation of Bar Associations and local bar associations shall establish the Regulations concerning the Standards for Attorneys' Fee before 2004. The Federation, complying with the requirement of the Attorney Act, published an attorney's fee schedule, and almost all local bar associations followed the schedule of the Federation. While both the Federation and the local bar associations abolished their fee schedules after the 2004 revision of the Attorney Act withdrew the requirement to establish fee schedules, many lawyers have drawn up their own fee schedule with almost the same content as the past fee schedule of the Federation. In the common practice of a civil action case, attorneys charge their clients a non-refundable retainer (*chakushukin*) and a "success fee" (*seiko-hoshukin*). Both of them are calculated based on a sliding scale according to "the economic interests" of a client. Whereas the economic interests would generally mean the amount of damages claimed in an action in calculating the non-refundable retainer, it would basically be regarded as the amount of damages ordered by the court in a calculation of the success fee. The fee schedule of the

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[408] For an introduction as for the structure of the Japanese legal profession and the then general fee arrangement, see West, 'Why Shareholders Sue: The Evidence from Japan', above n 43, 365-372.

Federation was as follows:

Attorneys' Fee Schedule based on Fee Rules

Economic Interests	Retainer	Success Fee
Up to JPY 3 million (around GBP 18,000)	8%	16%
JPY 3 million - 30 million (around GBP 18,000 - 180,000)	5%+JPY 90,000(GBP 525)	10%+JPY 180,000(GBP 1,050)
JPY 30 million - 300 million (around GBP 180,000-1,800,000)	3%+JPY 690,000(GBP 4,000)	6%+JPY 1,380,000(GBP 8,000)
Over JPY 300 million (around GBP 1,800,000)	2%+JPY 3,690,000(GBP 22,000)	4%+JPY 7,380,000(GBP 44,000)

Note. The stering conversions are calculated at the currency rate as of 8 January 2016.

Let us now explain these common general practices of an attorney's fee in the context of derivative actions. In a derivative action case, two important issues arise from its nature. The first one is who will pay the fee. In a general civil case, since a plaintiff receives a benefit from the outcome of an action, it is fair that the plaintiff bears the cost of an attorney's fee. On the other hand, in a derivative action case, since it is not a plaintiff shareholder but rather the shareholders as a whole that enjoy the benefits from a win, a shareholder does not have any incentive to dare to bring an action and assume the burden of a fee by itself.[409] Rather, considering that the shareholders as a whole would gain benefits, it is justifiable to charge the company for an attorney's fee if the plaintiff wins.[410] Indeed, the Japanese Commercial Code provides that, in cases where a shareholder who has filed a derivative action wins the action (including cases of partially winning the

409 Reisberg, *Derivative Actions and Corporate Governance* , above n 9, 222-3.

410 Ibid, 248-250.

action), if the shareholder is to pay a fee to an attorney, the shareholder may demand that the company pay an amount that is found to be reasonable, not exceeding the amount of such fee, back to him/her.[411] Under this sort of regime, an attorney seeking to find a nominal plaintiff shareholder, therefore, would charge a non-refundable retainer fee much less in a derivative action case compared with a general civil case, or would not even bill such a fee at all. Instead, the attorney would expect to be paid the bulk of the fee later by the company.

Assuming the attorney generally depends on not the plaintiff but rather the deep pockets of the company to pay the fee, the vital issue, then, is how to calculate the fee. This is the second problem arising from the nature of derivative actions. In a general civil case, the fee is calculated based on a contract agreement between an attorney and its client. However, in a derivative action, given that a plaintiff shareholder is just self-selected,[412] and that an attorney in effect represents the interests of the shareholders as a whole rather than the plaintiff itself, the attorney should negotiate a fee not with the plaintiff but rather with the company.

Under the Japanese Commercial Code, in cases where a shareholder who has filed a derivative action wins the action, if the shareholder cannot reach an agreement with respect to a reasonable amount of an attorney's fee with the company, the shareholder will need to initiate an action against the company. The

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[411] The 1950 Code, s 268-2 (1), Companies Act 2005, s 852 (1).

[412] Cox, 'Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the Ali Project', above n 338, 960.

decision of a reasonable amount of the fee is left to the judgement of the court. The substantive issue is what should be viewed as the economic interests in a derivative action case. The interpretation in favour of the plaintiff's attorney would be to view the amount of damages upheld by a final and binding judgement as the economic interests. For example, suppose that this interpretation is applied to the Janome Sewing Machinery case, in which a final and binding judgement ordered five ex-directors to pay damages totalling around JPY 58,400,000,000 (around GBP 334 million as of 8 January 2016),[413] the economic interests would be the same amount as the ordered damages. Suppose also that Fee Rules are applied to the Janome case, the success fee would be over JPY 2,300,000,000 (around GBP 13 million as of 8 January 2016).[414] As this example well illustrates, to view the economic interests in a derivative action case as the damages ordered by the court would offer an attorney a massive incentive to find a nominal plaintiff.

It is, however, thought that the court, in practice, dominantly adopts a different approach that the economic interests in a derivative action case shall be deemed, in principle, as the damages actually paid by the defendant directors.[415]

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[413] *Suzuki v Unidentified*, Tokyo High Court, 23 April 2008, 1292 Kinyu Shoji Hanrei 14 (2008) (Tokyo High Court of Japan), Supreme Court, 2 October 2008 (2008) (Supreme Court of Japan).

[414] The success fee is calculated as follows: JPY 58,360,390,000*4%+JPY 7,380,000 =JPY 2,339,380,000.

[415] See, for example, *Sakai v Duskin Co., Ltd.* Osaka District Court, 14 July 2010, 2093 Hanrei Jihou 138 (2010) (Osaka District Court of Japan).

Taking into account that the funds of the individual defendant directors are more likely to be quite limited, and that the D&O insurance would generally cover the limited amount of damages in Japan,[416] the amount of the damages actually paid by the defendant directors would be much less than the damages ordered by the court. Suppose that, in the Janome Sewing Machinery case, the defendant directors together were able to pay only JPY 300,000,000 (around GBP 1.7 million) of the total damages of JPY 58,400,000,000 (around GBP 334 million). In such a case, the amount of the damages actually paid would be JPY 300,000,000 rather than JPY 58,400,000,000, and the expected success fee would be only JPY 19,380,000 according to the Fee Rules. Taking into account the facts that it took fifteen years for the plaintiff's attorneys to see the final and binding court decision after they brought the action,[417] the success fee of JPY 19,380,000 would be not profitable for them.

It, therefore, can be expected that a derivative action case would not necessarily be a profitable venture in Japan for a plaintiff's attorney. It would be possible to form a hypothesis on the basis of this practice regarding an attorney's fee that, since unnecessary derivative actions have not occurred frequently due to the lack of incentives, the demand for safeguards against such actions has not been

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[416] Although there is no empirical evidence, it is acknowledged in practice that insurance companies generally introduce a maximum insurance benefit of JPY one billion (around GBP 5,800,000 as of 8 January 2016).

[417] The Janome case was brought on 9 August 1993, and the final bounding decision of the Supreme Court was rendered on 2 October 2008.

urgently presented.

3.6. Comparison of the State of Use of Derivative Actions in the UK, the US and Japan>

Up to now in this chapter, we have looked at the history of derivative actions in Japan. An interesting perspective can be obtained if we compare the features we have confirmed through this with the state of the use of derivative actions in the US and the UK.

First, it suggests that the state of use of derivative actions is not simply determined based on their procedural requirements. The US and the UK have mechanisms for screening desirable derivative actions and undesirable derivative actions. However, no such mechanism is stipulated under the Companies Act in Japan. Despite this, derivative actions remained largely unutilised until the fixication of low costs for litigation were established under a revised law in 1993. This suggests that the actual state of the use of derivative actions is not determined solely on the procedural requirements, but also requires focus on the incentives and disincentives for the parties.[418] Similarly, in the US, attorneys have an economic incentive and most derivative actions are spearheaded by attorneys.

Second, societies differ in their approval of derivative actions, and it is believed that the relationship with other corporate governance tools gives rise to

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[418] Gelter, 'Preliminary Procedures in Shareholder Derivative Litigation: A Beneficial Legal Transplant?', above n 240.

these differences. The evaluation of derivative actions has transitioned in the US. As we saw in Chapter II, there was a positive assessment of derivative actions up through the 1940s, but with the increased number of derivative actions, including some that were abusive, a negative attitude took hold, and the advance screening of litigation claims and SLC expanded. Meanwhile, in Japan, despite the increase of the number of derivative actions since the 1993 revision of law, the view that the number of these cases should be reduced has not become the mainstream opinion. This may be because the governance model in Japan has distanced itself from that of the monitoring board which has become the worldwide standard, and for a long time, people promoted internally have become members of the board of directors to create internal management boards. In other words, since it has been a governance model with weak external monitoring as an alternative,[419] high expectations may have been maintained for management oversight through legal enforcement.

Third, it is possible that Japan's drastic legal system that lacks any screening of derivative actions has produced functions that are not seen in the US or the UK. As we say in Chapter II, a determination of whether or not to permit a derivative action on the basis of shareholder interests fails to take into consideration such external effects as general deterrence or the creation of legal rules, and may continue the low pace of use of derivative actions. Meanwhile, with the lack of a

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[419] John Buchanan, "Corporate governance as a local remedy for an unstable system: a demonstration from Japan", Tokyo University, ISS Research Series No.55 (2013).

screening mechanism in Japan, derivative actions have been actively utilised since the 1993 revision of law. If this has caused general deterrence, the creation of legal rules and the like functions to fully manifest, the lack of a screening mechanism can be said to also have a positive aspect. This issue is whether the derivative actions brought in Japan have actually been utilised to recover damages, suppress bad behavior, create legal rules or to otherwise contribute to the original purposes of the system. Empirical research is necessary and essential in order to evaluate this. The purpose of this thesis is to deepen such an examination.

3.7. Conclusion

The derivative action in Japan, in law, has a striking feature that the prerequisite for the initiation is very formalistic and the procedure is quite straightforward and easily accessible to the shareholders. It has also a feature that there is no screening mechanism to discourage unnecessary actions in terms of the best interests of the company. However, in practice, it seems reasonable to assume that notwithstanding the lack of safeguards, listed companies have not suffered badly from unnecessary actions. There are several possible explanations. In particular, both the Japanese version of the business judgement rule and the incentive problem for a plaintiff and its attorney would potentially cause the under-enforcement of derivative actions.

To evaluate these hypothetical explanations, the next chapter begins with an empirical analysis of derivative actions against directors of listed companies.

CHAPTER IV: COMPREHENSIVE INVESTIGATION INTO ALL DERIVATIVE ACTION CASES AT THE TOKYO DISTRICT COURT - METHODOLOGY AND OUTLINE OF ALL CASES -

4.1. Introduction

The primary aim of this research is to empirically examine whether derivative actions function as an effective corporate governance tool in Japan. A derivative action is the avenue by which minority shareholders are able to enforce the company's rights against directors where they have breached their duties.[420] The rationale for letting a self-selected plaintiff shareholder initiate a derivative action on behalf of the company is that the directors are not expected to optimally bring claims against their (ex-) colleagues.[421]

Much attention has been given to the issue of how to design the system for derivative actions with respect to the debate about corporate governance. The threat of a derivative action is thought to encourage directors to act in the interests of the shareholders as a whole, thus addressing the agency problem between dispersed shareholders and management.[422] Also, derivative actions would serve

[420] See generally Reisberg, *Derivative Actions and Corporate Governance* , above n 9,

[421] See Ch I above under 1.3.

[422] Ibid.

a function of the creation of legal rules.[423] However, there is a risk of side effects. In particular, given that the plaintiff shareholder is self-selected, the derivative action might be detrimental to the interests of the company because: (i) the plaintiff cannot be expected to have appropriate expertise and information in every case; (ii) the plaintiff does not necessarily have an incentive to consider the best interests of the company; or, (iii) the plaintiff may bring an opportunistic claim.[424] We, therefore, need to set a right balance between "accessibility" to derivative actions by shareholders and "safeguards" against abuse and inadequate use.[425] We must thus determine whether current derivative actions are being effectively used to mitigate the agency problem and whether companies suffer from the abusive or unnecessary derivative actions. An investigation of the realities of Japan's derivative action system will provide key evidence in the consideration of these issues. As addressed in the previous chapter, it is quite simple for a shareholder to file a derivative action in Japan.[426] Even a shareholder with a single share is able to file a derivative action on behalf of a company by completing the advance filing procedures. Notably, there is no screening mechanism in place for determining whether the filing of a derivative action and the pursuit of director liability will benefit shareholders as a whole or for dismissing actions that are found to run

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[423] See Ch I above under 1.3.7.

[424] See Ch I above under 1.3.5.

[425] Ibid.

[426] See Ch III above under 3.3.1.

contrary to the interests of shareholders as a whole.[427]

Such a system gives rise to a number of important issues:

(i) Are there more derivative actions filed in Japan than in other countries?

(ii) What types of shareholders bring derivative actions in practice?

(iii) What type of director liability is subject to derivative actions in practice?

(iv) What is the outcome for plaintiff shareholders? Do they win, lose or settle?

(v) Is the derivative action system being abused?

(vi) Does the trend differ between listed and closed companies?

(vii) Based on the total number of listed companies, is there a large or small number of derivative actions filed against listed companies?

The clarification of these trends and analysis of the background factors thereto will aid in a determination of whether derivative actions are serving their intended role. Accordingly, an empirical investigation and analysis is required on the derivative actions that have been filed.

However, these questions remain unanswered in Japan because of a lack of empirical research on the topic. Prior empirical studies regarding derivative actions in Japan relied on data provided by an irregular feature article titled "*Shuyona Kabunushi-Daihyo-Sosho Ichiran-hyo* [A List of ***Main*** Derivative Actions]", in the legal journal "Shiryo-ban Shoji Homu [Commercial Law - a Data

[427] Ibid.

Edition]", and supplemented this with other commercial databases. The latest edition of the article shows a list of 228 derivative action cases as of December 2018.[428]

On the other hand, as for the total number of derivative action cases, the official statistics of the Supreme Court reports the number of derivative actions newly brought each year and pending at the end of each year at district courts as follows.[429] The Tokyo District Court also reports the number of derivative actions newly brought each year as follows. [430]

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[428] Editors, 'Shuyona Kabunushi-Daihyo-Sosho Ichiran-Hyo [a List of Main Derivative Actions]', *Shiryo-ban Shoji Homu [Commercial Law - a Data Edition],* 416 (2018a), 140.

[429] Fukui, 'Kaishahou Sekougono Kabunushi-Daihyou-Soshou No Gaikyou [the General Report on Derivative Actions after the Enforcement of the Companies Act]', above n 276, 72; Editors, 'News', *Junkan Shoujihoumu,* 2170 (2018b), 64; Editors, 'News', *Junkan Shoujihoumu,* 2102 (2016), 49.

[430] Yoshida, 'Tokyo-Chisai Ni Okeru Shouji-Jiken No Gaikyo [Overviews on Commercial Litigation in the Tokyo District Court]', above n 382. Derivative actions fall under the exclusive jurisdiction of the district court having jurisdiction over the location of a company's head office (Japan's Companies Act, article 848).

Table 1: Number of Newly Filed Derivative Action Cases in All District Courts in Japan and the Tokyo District Court

Year	*All*	*Tokyo*	*Year*	*All*	*Tokyo*
1950 - 1989	10				
1990	4		2004	78	29
1991	5		2005	70	24
1992	12	5	2006	72	25
1993	-	18	2007	70	29
1994	-	35	2008	64	17
1995	-	22	2009	70	20
1996	68	16	2010	78	27
1997	88	36	2011	83	18
1998	73	22	2012	106	37
1999	95	30	2013	98	26
2000	84	17	2014	58	16
2001	66	17	2015	59	12
2002	78	20	2016	36	11
2003	85	20	2017	37	-
			Total	1648	549
			Mean	75.2	22.3

Note: The mean of number of newly filed derivative action cases in all district court and the Tokyo district cours shows the average case numbers for the period between 1996 and 2016.

Since the publishers of journals and databases tend to report sensational or unique cases and ignore trivial cases, the collected data from the prior research might be subject to selection bias. In fact, the editors of the above irregular feature article have told me that the list of main derivative actions used as the basis for the article was independently created by the editorial department of the journal, was sourced from legal journals containing judicial precedent, other published court cases, newspaper reports and other publicly accessible sources, and did not

cover all the derivative actions that had actually been filed. As indicated above, 1648 derivative actions have been filed in Japan between 1950 and 2017. The data relied on in prior studies accounts for only a portion of these cases, and the actions chosen were limited to those revealed in journals, newspaper reports and the like.

Furthermore, the prior studies merely examined the outcomes of the derivative actions contained in the foregoing list and did not conduct a full analysis regarding the details of each case. The prior studies only examined summaries of the respective cases contained in the foregoing list and rulings available to the public on databases and the like, and did not examine such matters as: (i) the characteristics of the plaintiff (such as his/her background, relationship with the company and the number of shares he/she has), (ii) the characteristics of the defendant, (iii) the characteristics of the company (such as whether it is listed or not), and (iv) the causes for the defendant director's liability as alleged by the plaintiff.

To best analyse the role of derivative actions, it would be better to look at all the derivative actions which have been filed to date. Under Japan's legal system, case records for civil litigation (complaints, answers, preliminary briefs, evidence and the like) are to be retained for a period of 10 years, and verdicts and records of settlements are to be retained for 50 years and 30 years respectively. Generally these case records and the like are made available for public inspection. An exhaustive study could be made by looking at the court records and other records for the derivative actions filed to date. The courts establish a "case

number" for all the derivative actions filed. With access to a list of the case numbers for these actions', it would be possible to conduct an examination of the actual court records. However, when I sought confirmation of this with the Secretariat of the Supreme Court, I learned that the number of derivative actions nationwide was being compiled and published based on information from the all District Courts, and that the Secretariat did not have comprehensive information regarding the case numbers for the respective actions. As such, it is effectively impossible to conduct a comprehensive examination of the derivative actions filed nationwide.

As an alternative, I looked into conducting a study of the derivative actions filed in the Tokyo District Court which account for approximately one-third of all actions nationwide. With the cooperation of Prof. Tomotaka Fujita, who is a leading corporate law academic in Japan, I enlisted the cooperation of the Tokyo District Court for this study. The Tokyo District Court replied that it has comprehensively managed the case numbers for existing derivative actions in its case management system since 2011. Ordinarily, lists of case numbers created using the case management system are not available to the public, but I was able to obtain a list on an extraordinary basis due to the importance of this study. In addition, I was also given a special opportunity to view the court records for all derivative actions (a total of 113 cases) concluded by the Tokyo District Court in a six year period from 2011 through 2016.

By examining the records for these cases, I will be able to make a

comprehensive study of all the derivative actions that were actually concluded within a set time period at the Tokyo District Court. Most companies have their headquarters located in Tokyo which is the economic centre of Japan, and as stated above approximately one in every three derivative actions nationwide is filed in the Tokyo District Court. This study will provide very important evidence for analysing the role that is actually being played by derivative actions.

Access to the list of the case numbers made it possible to conduct research based on hand-collected data sets and avoid a selection bias. The main purpose of this study is to provide new evidence, based on hand-collected data sets, on the frequency and dispositions of derivative actions in Japan.[431] The research will also investigate characteristics related to the plaintiffs, the subject companies, and the sued directors as well as the categories of director's liability claimed in the actions. These observations offer new clues as to what function derivative actions actually serve in Japan. First, in this Chapter, I will provide an explanation regarding the methodology and outlines of examined cases, then in Chapter V, I will provide an empirical studies as for derivative actions on behalf of listed companies, and for closed companies in Chapter VI.

4.2. Methodology

[431] Armour et al., 'Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States', above n 78.

With the cooperation of the 8th Civil Division of the Tokyo District Court, I examined all derivative actions reaching an outcome in the 8th Civil Division in the period between January 1, 2011 and December 31, 2016 (hereinafter, the "Studied Cases") by looking at court records.

This allowed me to investigate all the derivative actions brought in the Tokyo District Court during the stated time period, and to avoid, to a reasonable extend, the bias that comes with the selection of study cases. This was possible because derivative actions fall under the jurisdiction of the location of a company's head office.[432] Because I was able to cover derivative actions in a specific district court jurisdiction, I was able to encompass derivative actions of companies with head offices located in the jurisdiction. The 8th Civil Division serves as the commercial litigation section at the Tokyo District Court, and all derivative actions brought at the Tokyo District Court are remanded to this division.[433] The 8th Civil Division of the Tokyo District Court also has a database covering all the commercial actions adjudicated by this division, and I was able to use this database to identify all the derivative actions remanded to this division. With the special cooperation of the 8th Civil Division of the Tokyo District Court, I was able to obtain a comprehensive list of the derivative actions reaching an outcome in this division during the six year period between January 1, 2011 and December 31,

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[432] Companies Act s 848.

[433] Yoshida, 'Tokyo-Chisai Ni Okeru Shouji-Jiken No Gaikyo [Overviews on Commercial Litigation in the Tokyo District Court]', above n 382, 34.

2016. The cases contained in this list cover all the derivative actions for companies falling under the jurisdiction of the Tokyo District Court which reached an outcome in the stated period, making it possible to investigate all these cases as Studied Cases.

There would be potentially a selection bias for this research by selecting all cases that reached an outcome within the prescribed time period, on a "case ending basis." Another method for comprehensively identifying derivative actions within a set time period would be to extract all the cases filed within that time period, on a "case filing basis." However, it was impossible to extract all the cases from the Tokyo District Court, 8th Civil Division's database using this method, so I decided to focus the research on all cases reaching an outcome in the prescribed time period. This selection method still harbors a risk of bias based on the composition of judges in this division during the corresponding time period and other factors. For example, in theory, there is a possibility that the judges acted expediently in the processing of cases and reached outcomes in a large number of cases during this period. However, the effect of this bias would likely be minor since the length of the study was comparatively long at six years, and the composition of judges remains fluid due to routine reassignments.

Next, from July of 2016 through January of 2017, I investigated all the Studied Cases by looking at the court records for these cases in order. The court records kept by the court are organised in to three classifications: Class 1 (written records of hearings, complaints, written answers, preliminary briefs and other

written claims); Class 2 (inventories of evidence, petitions for evidence, explanations of evidence, documentary evidence, etc.); and, Class 3 (service reports, powers of attorney, petitions related to orders for submission of documents and orders for the provision of security, etc.). I looked at all these court records.[434] By looking at all the court records for the Studied Cases, I was able to collect detailed data regarding such matters as the background circumstances, the advancement progress of the litigation, the details of settlements and the like.

4.3. Overview of Studied Cases

The research covered a total of 113 cases. That is an average of 18.8 cases per year.[435] An overview of these cases is provided below.

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[434] Those case records subject to restrictions on inspection under section 92 of the Code of Civil Procedures were excluded from review.

[435] Many of the identified derivative actions brought by shareholders were intervened by other shareholders as co-parties. These cases shared specific claims for compensation of damages against company directors so they were counted as one case and not as one case per plaintiff shareholder. In addition, for some reason there were two derivative actions filed for the same demands and causes between the same parties which were subsequently consolidated into a single case. These cases were counted as one case consolidating two cases.

4.3.1. Number of Companies Subject to Research

There were a total of 96 companies covered by the 113 Studied Cases. There were fewer companies than cases because some companies had suffered more than one derivative action. Specifically, 32 cases were brought against 15 companies and 81 causes were brought against 81 companies. Therefore, there were a total of 113 cases on behalf of 96 companies.

While there are a variety of reasons as to why multiple actions would be brought against a single company, the one reason that stood out was procedural deficiencies arising after an action was been filed, where the plaintiff shareholder would have a case thrown out for procedural reasons and then would re-file the case under the same demands. As a result thereof, there were multiple cases for substantially the same dispute. In addition, I saw a number of cases where for some reasons the shareholders filed separate cases against directors and auditors for the same dispute. Since there were a number of instances where multiple actions were brought with regard to substantially the same dispute, if had I focused my verification on the number of Studied Cases, those cases that in essence should have been counted as a single case would have be counted as multiple cases, and there would have been a risk of bias in the verification results for the research. Therefore, the research combined both analysis based on the number of cases and analysis based on the number of companies where needed.

4.3.2. Outcome of Studied Cases

The outcomes of the 113 Studied Cases are set forth in Table 2.

Table 2: The Outcome of Studied Cases

	No.	Ratio
Judgment	51	45.1%
Upholding a Claim	14	12.4%
Dismissing a Claim	28	24.8%
Dismissing a Claim Without Prejudice	9	8.0%
Acknowledging a Claim by Defendant	1	0.9%
Entering into a Settlement	29	25.7%
Withdrawing an Action by Plaintiff	32	28.3%
Total	113	100.0%

Just 51 or less than half of the cases resulted in a ruling (45.1% of the 113 cases). Of these, 14 cases were upheld (12.4%), 28 cases were dismissed on the merits (24.8%) and 9 cases were rejected (8.0%). One case ended in an admission of claims (0.9%). 29 or roughly one-fourth of all the cases ended in settlement (25.7%). But some of these cases ended in a ruling at the lower court and resulted in a settlement upon appeal. As addressed later, 27 of these 29 settlement cases involved closed companies. Only two cases involving listed companies ended in settlement.

In 32 or just under 30% of all cases, the plaintiff shareholders withdrew their complaints (28.3%). With 23 of these cases, it can be deduced that the plaintiff shareholders withdrew their complaints due to clear procedural

deficiencies. Often there were defects or inadequacies in the filed claims.[436] The most common inadequacy in the filed claims was claims that were brought against the wrong party. Typically, claims that should have been filed against auditors were filed in the name of the representative director.[437] Additionally, there were claims that were filed with auditors despite the fact that an auditor's powers are limited to accounting audits, and they do not have the authority to receive filed claims.[438] Most of the cases withdrawn for procedural deficiencies were withdrawn by the plaintiff shareholders prior to the designation of the initial date for oral arguments. It is likely that the procedural deficiencies were identified when the court examined the complaints, and the plaintiff shareholders were told of the deficiencies prior to the designation of the initial oral argument date, and the voluntarily withdrew their proceedings. Only two of the 20 withdrawn cases thought to have been withdrawn for procedural deficiencies involved pro se lawsuits, and the plaintiff shareholders opted for legal representation in the other 18 cases.

With regard to the 32 withdrawn cases, of the 12 remaining cases exclusive of the 20 cases where clear procedural deficiencies existed, seven cases were withdrawn after several hearing dates (the detailed reasons for these are unknown), one is thought to have been withdrawn after the company when bankrupt, one is

[436] Companies Act s 847 (1).

[437] Companies Act ss 386(2), 399-7(5), and 408(5).

[438] Companies Act ss proviso of section 2 (9) and 386(2)(i).

thought to have been withdrawn after the plaintiff shareholder took over management of the company through a separate shareholder proposal and proxy solicitation, one case is thought to have been withdrawn after the plaintiff shareholder sold off its shares, and two where withdrawn for unknown reasons.

4.3.3. Difference between Listed Companies and Closed Companies

Of the 113 Studied Cases, 29 cases involved listed companies (25.7% of the 113 cases),[439] and 84 cases involved closed companies (74.3%). If you look at the 96 companies subject to litigation, 22 were listed companies (22.9% of the 96 companies) and 74 were closed companies (77.1%) (see Table 3 below). In other words, listed companies account for only approximately one-fourth of the derivative actions that are actually filed, while closed companies account for the majority of the cases. This phenomenon was previously identified by judges,[440] and confirmed by this research.

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[439] A company is determined to be a listed company if it is listed as of the time of the occurrence of the facts serving as the key cause of the claims and not as of the time of the filing date of the action.

[440] Fukui, 'Kaishahou Sekougono Kabunushi-Daihyou-Soshou No Gaikyou [the General Report on Derivative Actions after the Enforcement of the Companies Act]', above n 276.

Table 3: Nubmer of Cases on Behalf of Litsted and Private Companies

On a Case Number Basis	No.	Ratio
Listed Companies	29	25.7%
Private Companies	84	74.3%
Total	113	100.0%

On a case Number Basis Excluting Refile Cases	No.	Ratio
Listed Companies	27	26.5%
Private Companies	75	73.5%
Total	102	100.0%

On a Company Numer Basis	No.	Ratio
Listed Companies	22	22.9%
Private Companies	74	77.1%
Total	96	100.0%

4.4. Significance of Research

Compared to prior studies,[441] the analysis of this research is significant in that it accurately reveals the realities of derivative actions with regard to the following

[441] West, 'Why Shareholders Sue: The Evidence from Japan', above n 43; Fukuda Mitsuo, 'Kabunushi-Daihyou-Soshou Ha Koporeito Gavanansu No Shudan Toshite Yuukouka[Is the Derivative Action an Effective Tool for Corporate Governance?]', in Hiroshi Osano (ed.), *Gendai No Kinyu to Seisaku[Modern Finance and Policy]* (Nihon-Hyouron-Sha, 2000), 347; Dan W. Puchniak and Masafumi Nakahigashi, 'Japan's Love for Derivative Actions: Irrational Behavior and Non-Economic Motives as Rational Explanations for Shareholder Litigation', *Vanderbilt Law Review,* 45/1 (2012), 1; Kenichi Osugi, 'Kabunushi-Daihyou-Soshou Ha Wagakunide Donoyouni Kinou Shiteiruka[How Do Derivative Actions Funciton in Japan]', in Etsuro Kuronuma and Tomotaka Fujita (eds.), *Kigyou-Hou No Shinro-Egashira Kenjirou Sensei Koki Kinen[the Road of Corporate Law-Commemorative Collection of Academin Papers for Celebration of Seventy Yeal Old of Prof. Kenjiro Egashira]* (2017), 291.

two points.

First, this research covers all derivative actions reaching a conclusion in the Tokyo District Court over a six year period. Prior studies created data sets based on a published "List of Main Derivative Actions,"[442] and failed to examine all actual derivative actions. If all cases are not examined, absent random selection there is a risk of bias in the analysed results. The cases covered in these prior studies were limited to those published in case reporters, databases,

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[442] Of the prior studies stated in the preceding note, West, 'Why Shareholders Sue: The Evidence from Japan', above n 43, Mitsuo, 'Kabunushi-Daihyou-Soshou Ha Koporeito Gavanansu No Shudan Toshite Yuukouka[Is the Derivative Action an Effective Tool for Corporate Governance?]'., above n 441, and Puchniak and Nakahigashi, 'Japan's Love for Derivative Actions: Irrational Behavior and Non-Economic Motives as Rational Explanations for Shareholder Litigation', above n 441, created data sets that relied on a "List of Main Derivative Actions" routinely published in the Shiryoban Shoji Homu [Commercial Law Data Edition] (most recently, Editors, 'Shuyona Kabunushi-Daihyo-Sosho Ichiran-Hyo [a List of Main Derivative Actions]', above n 428). Osugi, 'Kabunushi-Daihyou-Soshou Ha Wagakunide Donoyouni Kinou Shiteiruka[How Do Derivative Actions Funciton in Japan]'., above n 441, built a data set based on the "Yakuin Sekinin (Kaisha ni taisuru Nimu Ketai Sekinin) Ichiran [List of Officer Liability (Liability to the Company for Negligence of Duties)]" published in Minoru Sawaguchi, *Atarashii Yakuin Sekinin No Jitsumu [New Practice in Officer Liability]* (2nd edn.: Shoujihoumu, 2012), but the "List" collects base date from information in publications, cases listed on court websites, the content of electronic public notices and the research results of the Japan Institute of Business Law (Ibid, 348.), and they likely referred to the "List of Main Derivative Actions" routinely published in the Shiryoban Shoji Homu [Commercial Law Data Edition] in this effort.

newspapers and other sources, which preclude random selection. In contrast, this research covers (i) the derivative actions for companies with head offices under the jurisdiction of the Tokyo District Court, and (ii) all cases reaching an outcome in a six period between 2011 and 2016. In other words, this research investigated all cases for a set location and a set time period, and should be relatively free of selection bias.

Actually, the results of this research revealed that many derivative actions are not captured on the databases relied on in prior studies. Of the 113 derivative actions reaching an outcome in the Tokyo District Court in the six year period, only 29 cases involved listed companies. Nevertheless, 14 or nearly half of these cases were not included in the "List of Main Derivative Actions" relied upon in many previous studies.[443]

This serves as a factor in the mistaken image regarding the realities of derivative actions at listed companies. Some prior studies have indicated that

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[443] See preceding note 442. Moreover, Osugi, 'Kabunushi-Daihyou-Soshou Ha Wagakunide Donoyouni Kinou Shiteiruka[How Do Derivative Actions Funciton in Japan]'., above n 441, used the data in the ""Yakuin Sekinin (Kaisha ni taisuru Nimu Ketai Sekinin) Ichiran [List of Officer Liability (Liability to the Company for Negligence of Duties)]" stated in Sawaguchi, *Atarashii Yakuin Sekinin No Jitsumu [New Practice in Officer Liability]* , above n 441, but 12 of the 29 cases involving listed companies in this study were not included in the most recent data in the most recent version of Minoru Sawaguchi, *Atarashii Yakuin Sekinin No Jitsumu [New Practice in Officer Liability]* (3rd edn.: Shoujihoumu, 2017).

ombudsman and others were the main plaintiffs in derivative actions involving listed companies.[444] However, I discovered that in reality only roughly 20% of the derivative actions brought against listed companies are filed by such plaintiffs.[445] This suggests that the data relied on in previous studies not only lacks in comprehensiveness, it may also be plagued by bias in the selection of the case studies. While it is unclear as to what basis was used in the lists relied on in previous studies, if they captured derivative actions published in was case reporters, newspaper articles and databases, they likely included only those cases that caught the public's attention or cases actively publicised by the relevant parties. If that is the case, it is likely that the prior studies are biased toward famous cases and cases for which the related parties have a motive for making them public.

Second, another feature of this research is its examination of actual court records in derivative actions, which made it possible to look at the circumstances surrounding the backgrounds and trial processes for the cases. The court records consist of the complaints, written answers, preliminary briefs and documentary evidence submitted by plaintiffs and defendants as well as the written records of hearings and other records created by the courts. Such information cannot be gleaned from published decisions. In addition, I was able to examine the details

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[444] Puchniak and Nakahigashi, 'Japan's Love for Derivative Actions: Irrational Behavior and Non-Economic Motives as Rational Explanations for Shareholder Litigation', above n 441; Osugi, 'Kabunushi-Daihyou-Soshou Ha Wagakunide Donoyouni Kinou Shiteiruka[How Do Derivative Actions Funciton in Japan]'., above n 441.

[445] See Ch V below under 4.3.3.

of settlements in those cases that ended in settlement, and I was able to confirm how these derivative actions were ultimately resolved. This made it possible to accurately observe and analyse the realities of derivative actions. Such a comprehensive empirical study of derivative actions is a rarity even in other countries.

All of the cases covered in this research are summarised and discussed in next two Chapters below.

CHAPTER V REALITIES OF DERIVATIVE ACTIONS ON BEHALF OF LISTED COMPANIES

5.1. Introduction

I will provide an explanation of the results of my investigation on those Studied Cases that involved derivative actions brought with regard to listed companies, and provide analysis regarding the background factors thereto in this Chapter.

5.2. Number of Cases on Behalf of Listed Companies and Number of Companies Involved

5.2.1. Outlines

As addressed in Ch IV, 29 of the 113 Studied Cases were brought on behalf of listed companies, and 22 listed companies were involved in these cases. There were fewer companies involved than number of cases brought because a total of five listed companies accounted for a total of 12 derivative actions.

This is the number of cases and the number of companies involved in the six year period subject to my investigation. Annually, each year an average of 4.8 derivative actions are concluded with respect to 3.7 listed companies with head

offices located in Tokyo. Two of the 29 cases were withdrawn after filing for procedural deficiencies, then re-filed under the same claims and concluded during the time period studied. As such the two cases that were filed and then withdrawn for procedural deficiencies were substantially the same as two subsequently re-filed cases. If the initially filed actions are excluded, there was a total of 27 cases on behalf of 22 listed companies, or an average of 4.5 actions on behalf of 3.7 companies per year.

5.2.2. Percentage of Listed Companies

The number of listed companies having head offices in Tokyo needed to be examined in order to assess whether there were numerous cases or few cases. I looked into this and confirmed that as of August 11, 2017, 1,863 listed companies had their head offices in Tokyo. 1,854 of these companies are listed on the Tokyo Stock Exchange, eight are listed on the Nagoya Stock Exchange (excluding those also listed on the Tokyo Stock Exchange), one is listed on the Sapporo Securities Exchange (excluding those also listed on the Tokyo Stock Exchange), and none are listed on the Fukuoka Stock Exchange.[446]

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[446] With regard to the companies listed on the Tokyo Stock Exchange, those having their head offices in Tokyo were selected using the Japan Exchange Group's "Corporate Governance Information Services", resulting in 1,858 companies as of August 11, 2017. With regard to the companies listed on the Nagoya Stock Exchange, the Sapporo Securities

Therefore, it is found that 22 or 1.2% of these 1,863 companies saw the conclusion of derivative actions in the six year study period. Annually, 3.7 or 0.2% of the 1,863 companies found the end of derivative actions each year.[447] While it is difficult to make a categorical assessment regarding the annual average of 3.7 companies or 0.2%, the number seems lower than the number of cases for other types of litigation. Also, it would be reasonable to assume that there is a low rate of derivative actions with regard to listed companies especially compared with the situation in the US where 141 derivative actions were filed on behalf of public companies in the federal court in one year from mid-200 through mid2006.[448]

Exchange and the Fukuoka Stock Exchange, I first selected companies that were not also listed on the Tokyo Stock Exchange, determined how many of these companies had head offices in Tokyo, and confirmed the numbers stated above. As such, there are eight companies listed on the Nagoya Stock Exchange and one company listed on the Sapporo Securities Exchange that have their head offices in Tokyo and are not also listed on the Tokyo Stock Exchange.

[447] While ordinarily there would be fluctuations in the number of listed companies having their head offices in Tokyo, I determined that this fluctuation was not significant, and used the 1,863 listed companies as of August 11, 2017 as the basis for my calculations. In addition, these 1,863 companies include companies that have head offices which fall under the jurisdiction of the Tachikawa Branch of Tokyo District Court and not the jurisdiction of the 8th Civil Division of the Tokyo District Court. Since this only accounts for a small portion of the overall number of listed companies, I did not determine the number and excluded these companies from my calculations.

[448] Erickson, 'Corporate Governance in the Courtroom: An Empirical Analysis', above n 38, 1770. See Ch II above under 2.3.5.

5.2.3. Are there Too Few Derivative Actions?

The question of whether the number and rate of derivative actions at listed companies is too few when compared to the originally desired level is difficult to be answered empirically and there are a variety of evaluations with respect of the number and the rate.

For example, assuming there are a limited number of potential cases in which it is best to pursue liability through a derivative action, and compared to the number of potential cases, the annual average of 3.7 companies or 0.2% can be assessed to be sufficient. Liability does not necessarily have to be pursued by derivative actions even in those instances where there is serious mismanagement or wrongdoing. If a specific director is suspected of neglecting his/her duties, the director could resign, be dismissed, not be reappointed, his/her director remuneration could be returned or reduced, or the director could voluntarily provide compensation or take responsibility by other means. In addition, a company could pursue liability and seek compensation at the judgment of the board of directors or the auditors. Derivative actions work best when these other means are not taken or are insufficient and the pursuit of liability against the director is required in order to recover damages or discipline management.[449] If

[449] For detailed discussions regarding functions and side-effect of litigation costs, see Ch I above under 1.3.

there are not a lot of cases where such necessity exists, then the number of derivative actions that are actually brought are not lower on the optimum level.

Conversely, if there are a considerable number of cases where it would be best to pursue liability by derivative actions for the foregoing reasons but derivative actions are filed only in a portion of these cases, then the number is lower than the number of derivative actions that should be brought.

In order to determine which of these assessments is reasonable, the potential of how many cases in which it would be best to pursue liability through a derivative action must be identified, and such identification is realistically difficult. However, considering that the annual average of 3.7 companies or 0.2% is not that large, it might be possible to assume that the latter inference that too few actions are being filed would be reasonable.

5.2.4. Why Too Few Derivative Actions?

What factors underlie the small number of derivative actions brought on behalf of listed companies and the large number of actions that are not filed in those instances where it would be best to pursue liability? Below I will address the procedural factors that inhibit actions, the information asymmetry issue, the lack of incentives, and the costs incurred by a company through the filing of a derivative action.

5.2.4.1. Existence of Procedural Barriers

The first possible factor for too few actions may be the practical barriers of the difficulty shareholders experience in utilising the derivative action system and their hesitance in becoming plaintiffs. However, as addressed in Chapter III, Japan's derivative action system makes it easy for shareholders to file actions.[450] A shareholder, excluding a holder of shares less than one unit,[451] who has continuously held shares for the past six months is able to file a derivative action if he/she requests the filing of action to the company, and the company fails to file an action within 60 days.[452]

One practical barrier may be the costs involved in filing an action, however this has been addressed. First, though a plaintiff shareholder is required to pay court fees when filing a derivative action, the cost of filing has been set at a uniform JPY 13,000 (around GBP 94 as of 11 June 2019).[453] Also, if the shareholder loses, the possibility of owing damages to the company has a certain

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[450] See Ch III above under 3.3.1.

[451] A stock company may provide in the articles of incorporation to the effect that holders of shares less than one unit may not exercise some or all rights other than certain prescribed rights, with respect to the relevant shares less than one unit under Companies Act s 189 (2).

[452] Companies Act s 847 (1) and (3).

[453] Act on Costs of Civil Procedure, s 4 (2), Attached Table 1. See Ch III under 3.4.1 and 3.4.2.

chilling effect.[454] However, considering that a shareholder is only liable for damages if maliciousness exists,[455] it can be said that this chilling should not be worried about too much in practice. No other practical barriers come to mind which may keep a plaintiff shareholder from filing an action.

Therefore, it would be possible to presume that Japan's derivative action system allows a shareholder to self-select to easily become a plaintiff on behalf of the company, and addresses the issue of the filing costs and potential liability for damages if losing the case.

5.2.4.2. Information Asymmetry Problem

If there are too few actions being brought, then what factors are work? The first that comes to mind is the possibility that the uneven distribution of information serves as a barrier to the filing of actions. Since shareholders leave the execution of a company's business to the directors, the information available to shareholders is basically limited to public information, and they are unable to access the internal information arising from day to day operations. As a result thereof, even if circumstances worthy of a derivative action arise, the shareholders may not know the facts and there may be no impetus for the filing of a derivative action. Furthermore, even when a shareholder becomes aware of circumstances which

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[454] See Ch II above under 2.2.2.

[455] Companies Act s 852 (2).

may require the pursuit of liability, if there is no access to the detailed internal information, the shareholder may be unable to collect and secure evidence to prove the cause of the claim against the director, and may ultimately forego filing an action.

Under the Companies Act, as means for the collection of information and evidence for the pursuit of liability, a shareholder is provided with a right of claim to inspect the minutes of the board of directors of the company and its subsidiary companies,[456] right of claim to inspect the accounting ledgers of the company and its subsidiary companies,[457] and a right of claim to appoint an inspector regarding the execution of business.[458] In addition, a petition for an order to submit a document may be utilised once an action is filed.[459] However, without any clues, it is difficult to exercise these rights on an exploratory basis to collect information and evidence in order to pursuing liability.

This structural unevenness in the distribution of information makes the actual filing of an action a rare occurrence even in potential cases where a derivative action would be best means for pursuing liability, and this may lead to too few cases being filed with regard to listed companies as a whole.

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[456] Companies Act s 371(2), (3) and (5).

[457] Companies Act s 433.

[458] Companies Act ss 358 and 868 (1).

[459] Code of Civil Procedure s 221.

5.2.4.3. Lack of Monetary Incentive

Another factor may be the lack of a monetary incentive for plaintiff shareholders and the attorneys who represent them.[460] With regard to the monetary incentive for plaintiff shareholders, unless some type of arrangement is made, a derivative action may suffer from the so-called free-rider problem in economics. While derivative actions function to compensate damages, if the plaintiff shareholder prevails at court, the defendant director will compensate the company and not the plaintiff shareholder. Accordingly, the benefits gained through the compensation of damages are enjoyed by all shareholders. Derivative actions also function to make the management accountable, and if this results in an effort of the management to maintain or improve a company's corporate value, the benefits are shared by all shareholders, and the prevailing plaintiff shareholder merely receives a pro rata benefit based on his or her shareholding ratio. Therefore, in most cases the monetary benefits for a plaintiff shareholder to bring a derivative action and win in the end does not exceed the costs required in the filing and pursuit of the action.[461]

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[460] For detailed discussions as for the incentive problem, see Ch I above under 1.3.3.

[461] As an exception, a plaintiff shareholder who holds more than a certain percentage of shares may expect the pro rata benefits he gains based on his shareholding ratio to exceed the costs, and to overcome the free-rider issue. However, such a shareholder may also be able to exercise considerable influence over management by electing or dismissing directors at general meetings of shareholders and punishing management without having to

Alternatively, derivative actions can be driven by lawyers as actions led by attorney account for majority of the derivative actions filed in the US.[462] The monetary incentive for an attorney is affected by his or her fee system and fee level.[463] An attorney who prevails in a case may earn considerable fees if suspicions of a director's breach become public at a specific listed company, and the attorney actively seeks out potential plaintiff shareholders to serve as their attorney in the filing of an action. In Japan, a plaintiff shareholder who prevails in a derivative action is able to seek reasonable attorney fees from the company in law.[464] Accordingly, the attorney and not the plaintiff shareholder would potentially have a monetary incentive for filing a derivative action with the expectation of fees from a company with deep pockets in theory.

However, in practice, under the current conditions, it would be possible to assume that an attorney's monetary incentive is not massive in Japan.[465] First,

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bear the costs of brining a derivative action, so a high shareholder ratio does not necessarily give rise to the filing of a derivative action.

[462] See Ch II above under 2.3.2 and 2.3.5.

[463] Hidefusa Iida, 'Nihon-Kigyou No Risuku-Teiku to Torishimariyaku No Minji-Sekinin-Ruru[Risk-Taking by Japanese Corporations and Legal Liability of Directors]', in Zenichi Shishido and Gen Goto (eds.), *Koporeito Gabanance Kaikaku No Teigen-Kigyou Kachi Koujou to Keizai Kasseika Heno Michisuji [Reforming Corporate Governance: The Road to Improving Firm Value and Stimulating the Economy]* (Shoujihoumu, 2016), 279.

[464] Companies Act s 852 (1).

[465] For discussion about the lawyer's incentive, see also Ch III above under 3.5.2.

currently competition among attorneys remains benign, so there may be little incentive to participate in derivative actions.[466] An attorney may be motivated to consider the expected returns of a case with calculating the likeliness of success and the anticipated amount of fees against the time, effort and expenses required in preparing and pursuing an action, and focus his or her attention on the cases with comparatively lower costs and higher fee expectations. This comparative weighting differs based on the type of litigation, and there is a possibility that derivative actions are not as attractive as other types of actions.

What is important in relation to this determination is how the attorneys' fees a plaintiff shareholder is able to seek from the company are calculated. It is possible that the method for calculating attorneys' fees may limit an attorney's monetary incentive. The amount of attorneys' fees borne by the company is set as "the amount found reasonable within the scope of the amount of compensation,"[467] and once a plaintiff shareholder prevails in an action, unless an arrangement is reached with the company regarding the fees it will pay, the final decision on the amount of fees borne by the company is left to the court. This places importance on how the court determines the company's burden in practice. In general, the amount of fees sought in a derivative action are not calculated simply based on the

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[466] Iida, 'Nihon-Kigyou No Risuku-Teiku to Torishimariyaku No Minji-Sekinin-Ruru[Risk-Taking by Japanese Corporations and Legal Liability of Directors]'., above n 463.

[467] Companies Act s 852 (1).

amount of courts' upholding judgment, rather the trend is to calculate an attorneys' fees based on the amount actually recovered.[468] Consequently, if the defendant director has limited assets, the contingency fees awarded even in a high-value action may be limited by the amount recovered. In particular, taking into consideration the fact that the level of remuneration amount awarded for listed companies' directors is lower in Japan than in the US or the UK,[469] it would be inferred that there would be a number of cases in which a defendant director's resources are much lower than the scale of the listed company's business. As such, even when a large amount is awarded in a case involving a generous claim, frequently the courts will take into consideration a defendant director's resources and only uphold a fraction of the awarded amount. It has also been pointed out that at present the maximum amount of compensation under D&O insurance is often quite low,[470] and the insurance money paid out under D&O insurance may serve as a limiting factor on the amount recovered. Under these circumstances,

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[468] Takahashi, *Tajū Daihyō Soshō Seido No Arikata : HitsuyōSei to Seido Sekkei [Design of Double Derivative Actions-the Need and System Design-]* , above n 26, 186. See also Ch III above under 3.5.2.

[469] Hideki Kanda et al., 'Zadankai-Yakuin-Houshu-Kaikaku No Shin-Cyouryu to Kongo No Kadai[Symposium: The New Trend and Future Issues of Remuneration Reform]', *Junkan Shoujihoumu,* 1987 (2013), 8, 13.

[470] Tomonobu Yamashita, *Tikujou D&O Hoken Yakkan[Explication: D&O Insurance Provisions]* (Shoujihoumu, 2005), 279; Takahashi, *Tajū Daihyō Soshō Seido No Arikata : HitsuyōSei to Seido Sekkei [Design of Double Derivative Actions-the Need and System Design-]* , above n 26, 151.

the amount actually recovered in a high-value ruling may not be so significant. This may result in lower attorneys' fees, and lead to little monetary incentive for attorneys to take the initiative in filing derivative actions.

In sum, it would be reasonable to conclude that there is little monetary incentive for either plaintiff shareholders or attorneys to bring derivative actions, and this is likely a factor in why too few actions being filed.

5.2.4.4. Burden of Continuous Shareholding

It is possible that other costs accompanying the filing of a derivative action may serve as a disincentive and the requirement of continuous shareholding may have an impact. A shareholder is required to continuously hold shares up through the conclusion of the case in order to bring a derivative action and remain the plaintiff. A shareholder will lose standing as a plaintiff in a derivative action if he/she sells his/her shares while the action is pending. This means that a shareholder is required to continuously hold the company's shares up through the conclusion of the derivative action, even if the action extends over a long time period. This can be a heavy burden. Becoming a plaintiff in a derivative action means the shareholder must waive his/her exit option regardless of stock price trends or whatever else might occur. The continuous ownership requirement makes a plaintiff shareholder locked into the sued company and makes it difficult for the plaintiff to diversify its investment, and may serve as a factor in significantly

increasing the costs of bringing a derivative action.

I examined the time periods from the filing dates through the conclusion dates of the Studied Cases in an attempt to validate this possibility. The mean time period for the 29 total cases was 16 months. If this is further examined by the difference of conclusion, the mean period for the cases concluded by judgment was 19.2 months, the mean period in the two cases where the claims were upheld was 38.5 months, the mean period in the 13 cases where the claims were dismissed on their merits was 23.0 months, and the mean period in the six cases in which the claims were rejected was 4.7 months. I confirmed that approximately two to three years is required to reach a conclusion in cases in which the plaintiff shareholder's claims are upheld or where a settlement is reached. An even longer time period is required if the case is appealed to the High Court or the Supreme Court.

The costs of having to continuously hold shares in court procedures can be significant for the shareholder since a case may extend into the long term, and this lack of an economic incentive may serve as a prominent inhibiting factor.

5.2.4.5. Externality of Derivative Actions

Another factor may be the hesitation of a reasonable shareholder to bring a derivative action due to the various costs accompanying the action related to the externality of derivative actions.[471] The most important function of derivative

[471] See Ch I above under 1.3.6.

actions is the ex-ante deterrent effect.[472] The existence of a derivative action system makes management aware of the possibility of the ex-post pursuit of legal liability if misconduct occurs, and serves as an incentive for proper management. Nevertheless, an ex-ante deterrent effect is no longer useful once a company experiences trouble. Once the misconduct has occurred, deterrence is no longer an issue; rather the issue becomes what key responses should be taken to recover damages and prevent future recurrences. The cost-benefit relation surrounding derivative actions changes once misconduct has occurred. For example, once a derivative action is filed, a company's internal information would possibly become public, its reputation would be damaged, and the company would incur significant costs in terms of time and labour to respond to the action. If misconduct occurs, it is not always best to simply pursue liability, and the quiet resolution of the issue without bringing a derivative action may benefit all shareholders. The deterrent effect of derivative actions ensures effectiveness from the general standpoint of corporate society through the strict pursuit of liability against a company where misconduct has occurred. However, the costs may outweigh the benefits at the company where the derivative action is brought. Shareholders at other companies may benefit the ex-ante deterrent effect when a shareholder brings a derivative action at a company were misconduct has occurred. That is to say that derivative actions may serve as an economic externality.[473]

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[472] See Ch I above under 1.3.2.

[473] See Ch I above under 1.3.6.

As such, a derivative action can serve as an activity for ensuring an ex-ante general deterrence in ordinary times before trouble has arisen, but once something has occurred, the filing of a derivative action to address the misconduct gives rise to a variety of costs, and foregoing a derivative action may be a reasonable option for the company. It is likely that shareholders of companies where troubles occur often choose not to file a derivative action based on the costs involved in the filing of the action. This externality of derivative actions may serve as a factor for underutilisation of derivative actions.

5.2.5. Summary

As addressed above, even though Japan's derivative action system was designed with shareholder ease-of-filing in law, each year only an average of 3.7 or 0.2% of the listed companies under the jurisdiction of the Tokyo District Court find the conclusion of derivative actions actually brought in practice. If this is less than the originally desired level of cases, the possible factors for the lack of actions include the information asymmetry, the lack of monetary incentives, the burden of the continuous ownership requirement, and the various cost incurred by a company through the filing of a derivative action. As an exception, it may be possible that derivative actions are being filed in limited cases where there is no information asymmetry problem or where the plaintiff shareholders or attorneys have non-monetary incentives or other personal motivations.

Then what type of shareholder actually engages in derivative actions? In considering of this question, I will look in detail at the attributes of plaintiff shareholders.

5.3. Derivative Plaintiff Shareholders

The best thing to do to facilitate the effective functioning of derivative actions is to have the action filed by a shareholder who will likely serve appropriately as a proxy for the interests of all shareholders. The Japanese derivative action system has not established a filing requirement for determining the fitness of the plaintiff shareholder, and derivative actions can be brought by any shareholder.[474] As such, derivative actions could be brought potentially by shareholders who may lack the requisite ability or information.[475] In addition, it is also possible that derivative actions may be exploited not for the original purpose of compensation and deterrence, but by an individual shareholder's motives for seeking private benefit. In examining the derivative actions that have actually been filed, there are serious questions as to whether the plaintiff shareholders held the appropriate expertise, information and motives for filing these actions. Hereunder I will examine the attributions of the plaintiff shareholders in detail to gain clues in ascertaining an

[474] See Ch III above under 3.3.1.

[475] For detailed discussions regarding the agency problem between a self-selected plaintiff shareholder and shareholders as a whole, see Ch I above under 1.3.5.

answer this question.

5.3.1. No Existence of Institutional Investors

In theory, one would expect institutional investors to be players in derivative actions.[476] The main means institutional investors have at their disposal for holding management accountable are their voice and their exit.[477] Another available means to address management misconduct is the filing of shareholder litigation. In particular, institutional investors often have people with expert skills and funds. Expectedly, the compensation of damages and deterrence would be effectively demonstrated in an action filed by an institutional investor in a case where the pursuit of liability is necessary. For example, reform has taken place in the United States to stimulate the filing of securities litigation by institutional investors.[478] In Japan as well, we have seen prominent cases in which institutional investors have pursued securities litigation when listed companies have engaged in fraudulent accounting or other fraudulent disclosures and the discovery of the falsified information causes share prices to decline sharply. In such securities litigation, the institutional investors are able to seek damages by

[476] Erickson, 'Corporate Governance in the Courtroom: An Empirical Analysis', above n 38, 1765.

[477] See Ch I above under 1.2.

[478] See generally Erickson, 'Corporate Governance in the Courtroom: An Empirical Analysis', above n 38, 1765-66.

asserting that the falsified disclosures induced them to purchase the shares at an inflated price.[479] As a result, there are a number of cases in which institutional investors have been awarded substantial damages.[480] A similar aggressive use of derivative actions by institutional investors would likely exert a stronger deterrent effect on management.

Nevertheless, securities litigation and derivative actions are completely different in terms of their incentive structures. Securities litigation is classified as direct litigation so that the damages are directly paid by the company to the plaintiff shareholder, and plaintiff shareholder is compensated for the damages caused by the disclosure of falsified information. As such, if a listed company is discovered to have disclosed falsified information, as long as it does not go bankrupt, efforts can be made to recover the damages by pursuing securities litigation. On the other hand, if the director at a listed company engages in wrongdoing and the company suffers losses, the damages paid from the filing of a derivative action by a shareholder go to the company and not the plaintiff shareholder. As such, the benefit enjoyed by a shareholder under a derivative action is merely the damages awarded pro rata based on his/her shareholding

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479 Financial Instruments and Exchange Act, ss 17-22.

480 See e.g., *Life Insurance Corp. v Livedoor Holdings Corp.*, Tokyo District Court, 1194 Hanrei Jihou 27 (2013), Tokyo High Court, Hanrei Jihou 33 (2146), Supreme Court, vol.66 no.5 Saikou Saibansho Minji Hanreishu 1957 (2012) (Tokyo District Court, Tokyo High Court and Supreme Court of Japan).

ratio.[481] Consequently, would-be plaintiff shareholders would lack incentives to file derivative actions. This free rider issue may explain why institutional investors are not proactive in the filing of derivative actions.

I examined the number of derivative actions that were actually brought by institutional investors to confirm whether or not this theory holds true. First of all, of the 29 examined derivative actions filed on behalf of listed companies, 25 cases were filed by individual shareholders, and only four cases were filed by corporate shareholders. Of the total 27 cases excluding the two cases in which the original complaints were withdrawn and re-filed, 23 cases were filed by individual shareholders, and only four cases were filed by corporate shareholders. As such only four derivative actions were filed by corporate shareholders. Additionally, of the four derivative actions filed by corporate shareholders, two were filed by large shareholders who had disputes with management. Both of them are not institutional investors. In one other case the plaintiff shareholder was a partner enterprise that had engaged in a capital tie-up with the sued company, and the remaining case involved a fund known to be an activist fund in Japan which is well known for making shareholder proposals and the like with multiple listed companies. It may be able to consider this plaintiff fund as an activist hedge fund, and also as an institutional investor.

As stated above, only one of the Studied Case was filed by an activist hedge fund, and no cases were filed by passive institutional investors. This stands

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481 For discussions as for the incentive problem, see Ch I above under 1.3.3.

in contrast to the securities lawsuits that are commonly brought by passive institutional investors to seek compensation for damages. Clearly, while it is common for institutional investors to file direct securities litigation, for the most part they are unwilling to utilise indirect derivative actions. Since direct litigation and indirect litigation differ in structure, it appears that institutional investors are influenced by the economic incentives from filing shareholder litigation.

5.3.2. A Few Derivative Actions Brought by Activist Hedge funds

Here I will touch on the existence of activist funds. Activist hedge funds have expanded their activities worldwide. Activist hedge funds used to be viewed adversarially, and referred to as "vulture funds," but opinion regarding these funds has evolved.[482] When activist hedge funds engage in shareholder proposals or proxy fights, passive institutional investors now support these efforts if the proposal or fight is reasonable. The activities of activist hedge funds have been confirmed to actually increase corporate value.[483] In Japan, activist funds have prominently tried to defend the interests of minority shareholders in squeeze-out

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[482] See generally Gilson and Gordon, 'The Rise of Agency Capitalism and the Role of Shareholder Activists in Making It Work', above n 80; Gilson and Gordon, 'The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights', above n 80.

[483] Ibid.

cases, and have campaigned in opposition to M&A's that are undervalued.[484] Activist funds have also prominently filed shareholder propositions seeking the reduction of holding other companies' shares as cross-shareholdings which they claim are responsible for inefficient management, and have won 20% to 30% support in some cases.[485]

Another effective option for activist funds that aggressively enforce shareholder rights would be to pursue derivative actions to correct management when issues arise at their investee enterprises. In particular, a fund with a considerably high shareholding ratio would be able to benefit from higher stock price trends through utilising a derivative action to recover damages and for the discipline of management. Additionally, an activist fund that pursued derivative actions would earn a reputation as an aggressive enforcer of shareholder rights, and could enhance its dialogue with management of other companies. This would facilitate the fund's activities and may lead to economic benefits.

However, as I previously stated, only one of the Studied Cases involved an

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[484] See, e.g., Yo Ota and Daisuke Matsumura, *Akutibisuto to Tekitaiteki-Baishu Taiou No Saizensen [the Front Line of Response to Actibist and Hostile Takeovers]* (Shoujihoumu, 2014).

[485] See, e.g., Tatsuya Makino, 'Kabunushi-Teianken No Jirei Bunseki - Heisei 29 Nen 7 Gatsu Soukai Kara Heisei 30 Nen & Gatsu Soukai Made [Case Studies on Shaholeders' Proposals from July 2017 to June 2018]', *Shiryo-ban Shoji Homu [Commercial Law - a Data Edition],* 414 (2018), 54.

activist fund plaintiff shareholder.[486] This underutilisation of derivative actions by activist funds despite their heightened activities would point to the existence of other structural factors, such as the asymmetry of information, the lack of incentives, the costs of the continuous holding of shares, and the costs to the company brought on by the filing of derivative actions.

5.3.3. A Few Block Holders and Many Small Holders

One key attribute of plaintiff shareholders is their shareholding ratio. For example, the higher a plaintiff shareholder's shareholding ratio, the greater the shareholder's desire for the serious and appropriate management of the company, and the greater the potential of shareholder's economic incentive for pursuing a derivative action. It may be possible to assume that a derivative action pursued by a block holder who holds a certain percentage of shares is more likely to serve as a reasonable means for ensuring the proper management of a company. However, a block holder who holds a certain percentage of shares may also be able to exert influence on management through its votes at a general meeting of shareholders. In particular, a major shareholder who holds more than 5% to 10%

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[486] This derivative action was brought by an activist fund holding approximately 8.4% of the company's shares. As described above under 5.3.1, the plaintiff in this case was an activist fund well known for its enforcement of shareholder rights against multiple listed companies.

of shares could seek the course change of management policies or the reshuffling of management through a dialogue with management without having to pursue to a derivative action. Therefore, in theory a major shareholder who holds more than 5% to 10% of shares would potentially lack the incentive to pursue a derivative action.

On the other hand, a plaintiff shareholder who holds only a small number of shares is unable to directly benefit, for the most part, when prevailing in a derivative action, and lacks a real economic incentive. A small shareholder who pursues a derivative action despite this is likely doing so for a motive other than an economic incentive.

As such, the plaintiff shareholder's shareholding ratio would hint at the shareholder's expertise and motivation for pursuing a derivative action. In this study, I was able to confirm the shareholder ratios for the plaintiff shareholders in 28 of the 29 Studied Cases based on the reasons for the judgments, the parties' preparatory briefs, evidence and other documents. The overall mean shareholding ratio was 1.3%, the median was 0.0% and the maximum was 13.9%. Of these 28 cases, the plaintiff shareholders held more than 5% of the shares in only two cases. In one the shareholding ratio was 8.4%, and in the other the shareholding ratio was 13.9%. In six cases the plaintiff shareholders held between 0.1% and 5% of the shares. In the other 20 cases the shareholders held less than 0.1% of the shares. Accordingly, the derivative actions pursued by shareholders holding more than 5% of the shares accounted for only a small portion of the Studied Cases (two cases /

7.1%), and the majority of the cases were brought by shareholders holding only a small number of shares.

The fact that only a small portion of the derivative actions were pursued by major shareholders suggests the issue of externality as discussed earlier.[487] A company incurs a variety of costs in the filing of a derivative action through such factors as the divulgence of its internal information and the effect on its reputation. Such costs have a direct impact on the economic positions of major shareholders. Taking into the above findings account, it can be said that in a case which major shareholders recognise some issues with management, they are more likely to forego the use of derivative actions considering their accompany costs, and to discipline management through a dialogue or through the use of their "voice" instead in Japan.

Meanwhile, the reality is that most derivative actions are pursued by shareholders who hold only a small number of shares. Tiny shareholders who hold only a small number of shares do not have the same influence as major shareholders in the context of ordinary corporate governance. On the other hand, when a tiny shareholder thinks that a derivative action is needed to hold the management accountable, he/she can file the action and the costs incurred by the company do not have material impact on the value of a small number of shares held by the tiny plaintiff shareholder. In particular, in Japan no threshold has been established for the shareholding ratio required to file a derivative action, and the

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[487] See above under 5.2.4.5.

filing fees payable to the court are a set JPY 13,000.[488] As a result, a shareholder who only holds a small number of shares is able to pursue a derivative action without hesitation.

5.3.4. A Few Lawyer-Driven Derivative Actions

In considering the economic incentives for pursuing derivative actions, a key factor would be the incentives available to the lawyers and not the plaintiff shareholders.[489] With regard to the monetary incentives for attorneys, those attorneys who repeatedly appeared as counsel in multiple cases may be attorneys who are taking the initiative in the filing of actions for monetary incentives.

It has been confirmed that a specific number of law offices are lead players in the filing of securities litigation and derivative actions in the United States. These lead players often file derivative actions in an attempt to reach an early settlement with the defendant to earn large fees[490]. The economic incentives available to the plaintiff shareholder's lawyers are a factor in most lawyer-driven derivative actions.

I examined whether or not this was the case in Japan, and, as described below, was unable to confirm that the same attorneys represented plaintiff

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[488] See Ch III above under 3.3.1.

[489] See Ch I above under 1.3.3. and Ch II above under 2.3.2.

[490] Ibid.

shareholders in multiple cases and that some cases were initiated by attorneys. Of the 29 Studied Cases, excluding of the shareholder ombudsman cases addressed below, I confirmed that no specific attorneys are filing multiple derivative actions.

The confirmation of the non-existence of lead player attorneys, excluding the shareholder ombudsman, in the Studied Cases suggests the lack of an economic incentive caused by attorney billing practices.[491]

5.3.5. Derivative Actions for Tiny Shareholders

As we have seen to now, most derivative actions are not brought by institutional investors, including activist funds, or major shareholders. The status of lawyer driven derivative actions has not been confirmed. The majority of derivative actions brought on behalf of listed companies have been filed by individual shareholders who hold only a small number of shares.

The issue is the motive of these tiny shareholders in brining derivative actions. Even when prevailing in a derivative action, the plaintiff shareholder only receives an indirect benefit based pro rata on the shareholder's shareholding ratio. Taking this structural characteristic into consideration, tiny shareholders are likely motivated to pursue actions by factors other than economic incentives. As addressed in Chapter I above, due to the structural problem of the lack of a monetary incentive in derivative actions, those cases in which actions are actually

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[491] See Ch III above under 3.5.2.

brought may be limited to instances where a plaintiff shareholder or an attorney has a non-monetary incentive or instances where the plaintiff shareholder has an inherent private interest.[492] In order to validate the reasonableness of this possibility, I decided to examine the attributes of the plaintiff shareholders and the background to the Studied Cases based on the records for these cases as well as the public information of listed companies, to deduce the motives and the backgrounds as to why plaintiff shareholders bring these actions.

5.3.6. Derivative Actions Filed Based on Non-Monetary Incentives

As addressed above, prior studies have identified that many derivative actions in Japan are brought by shareholder ombudsman and others for non-monetary incentives.[493] Certainly, in cases where the shareholder has a small holding of shares (typically one unit), and (i) the plaintiff shareholder or attorney is acting as a shareholder ombudsman, or (ii) the plaintiff shareholder has brought multiple shareholders litigation including derivative actions, it can be assumed that they filed derivative actions for non-monetary incentives. These derivative actions are likely brought based on the plaintiff shareholder's or their layers' principles or

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[492] See Ch I above under 1.3.3.

[493] Puchniak and Nakahigashi, 'Japan's Love for Derivative Actions: Irrational Behavior and Non-Economic Motives as Rational Explanations for Shareholder Litigation', above n 441; Osugi, 'Kabunushi-Daihyou-Soshou Ha Wagakunide Donoyouni Kinou Shiteiruka[How Do Derivative Actions Funciton in Japan]'., above n 441.

beliefs, and are filed for non-monetary incentives.

In actuality as well, there are a number of groups in Japan that profess to be acting as shareholder ombudsmen. One of the most famous groups is "the Lawyers Team for Shareholders' Rights". According to their website, this group was established in 2006, and currently has 20 affiliated attorneys and two affiliated certified public accountants. One purpose of this group's activities is to "engage in demands, petitions, trials, appeals, accusations and other actions with companies, competent authorities, securities exchanges and others on behalf of plaintiffs." The results of the activities are published on their website, and in bid-rigging cases they have specifically sought management compliance through derivative actions, and have reached settlements in cases with Hitachi Zosen, Kobe Steel, Sumitomo Metal, Mitsubishi Heavy Industries and IHI.[494]

This group states its foundational principle as follows: "*Corporate scandals (bid rigging, cartels, payoffs, dealings with organized crime, illegal contributions, accounting fraud, concealment of misconduct and the like) are never ending in Japan, and there is a lack of awareness and respect for corporate compliance. Amid this, we have established a defensive team for the realization of a better society by grappling with the oversight of management, the dealing with corporate scandal, and the seeking of management liability through the exercise of shareholders' rights and by allowing the development of corporations where*

[494] See <https://kabunushinokenri.com/> accessed 6 July 2019.

individuals actively do a work."[495] Accordingly, it can be assumed that this group uses derivative actions as a tool to heighten corporate compliance, and pursue derivative actions for non-monetary incentives.

More recently, a number of investors have acted individually to aggressively enforce shareholder rights without forming shareholder ombudsman like groups. One particularly well know individual investor is Mr. *Mitsuaka Yamaguchi*. When management at a listed company announces a management buyout (MBO), he often purchases the minimum unit of shares in that company and brings suit seeking an appropriate determination of the buyout price, alleging that the interests of general shareholders have not been given proper consideration.[496] He also files a number of proposals for resolutions at general meetings of shareholders of listed companies.[497] Mr. Yamaguchi publishes a blog regarding the status of activities for enforcing shareholder rights.[498] Like him, there are not a few shareholders seeking the purchase of shares and filing shareholder proposals at listed companies.[499] The activities of these individual shareholders are based on a belief that the enforcement of shareholder rights will

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[495] Ibid.

[496] See < http://blog.livedoor.jp/advantagehigai/> accessed 6 July 2019.

[497] Ibid.

[498] Ibid.

[499] See, e.g., Makino, 'Kabunushi-Teianken No Jirei Bunseki - Heisei 29 Nen 7 Gatsu Soukai Kara Heisei 30 Nen & Gatsu Soukai Made [Case Studies on Shaholeders' Proposals from July 2017 to June 2018]', above n 457.

lead to appropriate corporate governance and compliance at listed companies. Any derivative actions brought by these individual investors are likely based on non-monetary incentives. In particular, derivative actions brought by individual shareholders who, despite having only a small holding of shares, have enforced shareholder rights against multiple companies are very likely conducted for non-monetary incentives.

This study has looked at the existence of cases deemed to be brought for non-monetary incentives where the plaintiff shareholder has a small holding of shares, and either (i) a shareholder ombudsman is involved, or (ii) the plaintiff is an individual shareholder who has enforced shareholder rights at other listed companies. Of the 29 examined derivative actions on behalf of listed companies, three cases corresponding to item (i) above were brought on behalf of three companies, and two cases corresponding to item (ii) above were brought on behalf of two companies. These five cases account for 17.2% of the 29 cases involving listed companies, and 18.5% of the 27 cases excluding the two re-filed cases. The five companies subject to these cases account for 22.7% of the 22 listed companies involved in the Studied Cases. To summarise it, derivative actions brought for non-monetary incentives account for roughly 20% of all the cases filed on behalf of listed companies.

This differs from the conventional wisdom in prior studies. Previous studies identified that shareholder ombudsman and others served as the main

players in more than a few of the derivative action cases.[500] Nevertheless, there were only a limited number of five cases brought by shareholder ombudsman and others based on non-monetary incentives in these studies. It has not been confirmed as fact that a majority of the cases brought are filed based on non-monetary incentives.

These results suggest that the prior studies may have been affected by selection bias. As pointed out above under 4.4., these previous studies used the "List of Main Derivative Actions" as their primary source in the creation of their data sets.[501] Plaintiff shareholders or their attorneys bringing derivative actions for non-monetary purposes have incentives to publicise the fact that they have brought derivative actions so as to make their activities perceived broadly.[502] Also, they might inform newspapers, legal journals, database providers and the like of the derivative actions they have brought. Therefore, derivative actions brought by plaintiff shareholders or their attorneys for non-monetary incentives are more likely to become public and are included in the "List of Main Derivative Actions" without exception. In reality, although 14 of the 29 Studied Cases involving listed

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[500] Puchniak and Nakahigashi, 'Japan's Love for Derivative Actions: Irrational Behavior and Non-Economic Motives as Rational Explanations for Shareholder Litigation', above n 441; Osugi, 'Kabunushi-Daihyou-Soshou Ha Wagakunide Donoyouni Kinou Shiteiruka[How Do Derivative Actions Funciton in Japan]'., above n 441.

[501] See above n 441 and 442.

[502] As a matter of fact, a well-known shareholder ombudsman group in Japan has created its own website where it routinely chronicles the derivative actions it files.

companies were not published in the "List of Main Derivative Actions", all five of the cases filed based on non-monetary incentives were included in this list. Because of this selection bias, the percentage of these cases may be overstated in the list relied on by prior literature, which seems to give the impression that they actually account for majority of the cases filed.

5.3.7. Derivative Actions for Other Purposes

What then is the motive for most of the derivative actions that are actually filed? It has been identified that there is a fear that derivative actions are being exploited for personal interests.[503] For example, there are people who have had some type of dispute or trouble with a company or people who harbor personal grudges against management. These people may be motivated to pursue derivative actions to resolve a dispute with the company to their own advantage or to settle personal grudges. In particular, derivative actions in Japan merely require that the shareholder holds shares when filing an action and does not require that the shares were held when the trouble occurred.[504] Consequently, anyone who has a dispute with the company or management is able to purchase the company's shares and file a derivative action once a management related issue at the company becomes public. The primary purpose of this type of derivative action is more a means for

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[503] See Ch I above under 1.3.5.

[504] See Ch III above under 3.3.1.

resolving a plaintiff shareholder's specific interest than holding management accountable.

As such, I focused on the existence of separate disputes, issues and the like between the plaintiff shareholders and the defendant directors or the company other than underlying allegations of derivative actions. If there is such a special relationship between the parties, it can be expected that the plaintiff shareholders brought the derivative actions mainly based on their own inherent personal interests (hereinafter, "*Actions Filed for Other Purposes*"). Specifically, in cases where the plaintiff shareholders were confirmed to be (i) parties to a dispute over the control of the company, (ii) parties to labour disputes, such as ex-directors, ex-officers and ex-employees who were dismissed by the company, or (iii) parties to commercial disputes, the cases were deemed to possibly be Actions Filed for Other Purposes.

As a result of the examination, I determined that there were five cases on behalf of five companies under item (i), nine cases on behalf of four companies under item (ii), one of which was re-filed due to procedural deficiencies, and five cases on behalf of two companies under item (iii), one of which was re-filed due to procedural deficiencies. These 19 cases accounted for 65.5 % of the 29 cases on behalf of listed companies, and the 17 cases excluding the two re-filed cases account for 63.0 % of the total of 27 cases on behalf of listed companies. 11 of the companies involved accounted for 50.0 % of the total of 22 companies (see Table 4).

Table 4: Attributions and Motives of Plaintiff Shareholders

Of the 29 cases involving listed companies	No.	Ratio
Non-Moneraty Incentives	**5**	**17.2%**
Ombudsman	3	10.3%
Non-Ombudsman	2	6.9%
Actions Filed for Other Purposes	**19**	**65.5%**
Dispute Over the Control of the Company	5	17.2%
Dispute Over Labour	9	31.0%
Dispute Over Transactions	5	17.2%

Of 27 cases excluding the two refiled cases	No.	Ratio
Non-Moneraty Incentives	**5**	**18.5%**
Ombudsman	3	11.1%
Non-Ombudsman	2	7.4%
Actions Filed for Other Purposes	**17**	**63.0%**
Dispute Over the Control of the Company	5	18.5%
Dispute Over Labour	8	29.6%
Dispute Over Transactions	4	14.8%

Of the 22 companies sued	No.	Ratio
Non-Moneraty Incentives	**5**	**22.7%**
Ombudsman	3	13.6%
Non-Ombudsman	2	9.1%
Actions Filed for Other Purposes	**11**	**50.0%**
Dispute Over the Control of the Company	5	22.7%
Dispute Over Labour	4	18.2%
Dispute Over Transactions	2	9.1%

The detailed reasons for determining correspondence to the foregoing items (i) through (iii) are as follows. First, of the five cases involving (i) parties to a dispute over the control of the company, the first is a case where the plaintiff shareholder was the company's founder and former director who held 3.5% of the company's shares. There was kinship between the plaintiff shareholder and the defendant director. The former director was seeking to acquire management majority and exercised his shareholder proposal right seeking election of a candidate for director he nominated parallel to the filing of the derivative action. In the second case, the plaintiff was a competing company that was seeking a

business tie-up with the company and held 1.8% of shares. The plaintiff shareholder filed a shareholder proposal seeking election of a candidate for director the plaintiff nominated parallel to the filing of the derivative action, and engaged in a proxy fight. In the third case, the plaintiff shareholder was a former director holding a little less than 5% of the company's shares, who had a power game related to management control with the defendant director. In the fourth case, the plaintiff shareholder was a large-volume purchaser who acquired more than 10% of the company's shares. This plaintiff shareholder filed a shareholder proposal seeking the removal of the company's representative director parallel to his filing of the derivative action, and after requesting an extraordinary general meeting of shareholders, he sold all of his shares on the market and the derivative action was dismissed. The likely background to this case involved a dispute over management control between the plaintiff shareholder and the company's management. The fifth case was brought by a plaintiff shareholder who acquired just under 4% of the company's shares. This plaintiff shareholder filed a lawsuit seeking the nullification of a shareholder resolution in addition to the derivative action, and it is likely that there was a management related dispute with the company in this case as well.

Next, I will break down the nine cases on behalf of four companies that fall under item (ii) parties to labour disputes, such as ex-directors, ex-officers and ex-employees who were dismissed by the company. The first company had the derivative action filed by a number of current and former employees who belonged

to a labor union. The dispute involved a breach of the director's obligations to create an internal control system in response to a violation of environmental regulations. All directors named as a defendant worked in the Human Resources and Labor Relations Division. This derivative action was likely filed because of a conflict between the company and the labor union. The second company had the action filed by a former employee who was fired by the company. The former employee had brought a total of four derivative actions on behalf of companies where he had worked. The firing is thought to be the cause of this action. The third company had the derivative action filed by a former auditor, and it is likely there was a conflict between the former auditor and the defendant director. The fourth company had the derivative action filed by a former employee who was fired after whistle-blowing regarding misconduct by the company, and it is likely there was a conflict based on the dismissal following the whistle-blowing.

Finally, I will breakdown the five cases on behalf of two companies falling under item (iii) parties to commercial disputes. The first company had the action filed by a former representative director of a company which the sued company had invested in, and likely involved a commercial dispute between the companies. The second company had the action filed by a plaintiff shareholder who had a land transaction related dispute with the sued company. This plaintiff shareholder and persons related to this shareholder had filed a total of four derivative actions. The dispute between the plaintiff shareholder and the company started with a land transaction, and there were a number of lawsuits

between the parties including a defamation lawsuit. The cause of this action is considered to be a transaction related dispute.

As showed above, there were 19 Actions Filed for Other Purposes in which the plaintiff shareholders likely pursued and filed derivative actions for their own inherent interests (takeover of management, resolution of labour or commercial disputes, personal grievances and the like) and not mainly for the interests of shareholders as a whole. These 19 cases account for a majority or roughly 70% of the entire 29 cases on behalf of listed companies (roughly 60% based on the number of companies involved). The results of this research shed light on the fact that more than a few derivative actions are exploited for reasons other than the original intent of the system.

5.3.8. Issues Revealed by Trends in the Attributes of Plaintiff Shareholders

Based on the attributes of plaintiff shareholders as set forth above, there is an indication that the shareholder derivative actions brought at listed companies may not always be reasonable. If a plaintiff shareholder brings a shareholder derivative action for a non-monetary incentive, the true purpose for the filing of the action may be personal political beliefs, one's own social activism, a personal grudge against the company, capricious filing of actions (so-called litigiousness) or other purposes. In a broad sense, these can be called schemes for the realisation of personal gain. Shareholder derivative actions consume a defendant director's

time and energy, they divulge the companies internal information to the public, damage the company's reputation, have a chilling effect on directors, and other side effects. The costs of the actions are to be borne by all shareholders. If a plaintiff shareholder abuses shareholder derivative actions in order to realise personal gain, the other shareholders are the ones who bear the costs. The purpose of shareholder derivative actions is to secure the overall interests of shareholders through a recovery of damages function or suppression function, and as far as can be seen from the attributes of plaintiff shareholders, there are indications that the shareholder derivative actions at listed companies in Japan may not necessarily serve functions that are conducive to this original purpose.

5.3.9. Summary

As addressed above, the results of this research revealed the following points:

(i) Institutional investors, including activist funds, major shareholders and attorneys are not major players in Japan's derivative actions;

(ii) Most actually brought derivative actions are filed by shareholders with small shareholdings;

(iii) Approximately 20% of the derivative actions are likely filed for non-monetary incentives; and,

(iv) Approximately 70% of the derivative actions that are actually filed may be Actions Filed for Other Purposes based on the plaintiff

shareholders’ inherent interests.

Accordingly, it can be confirmed that the cases brought for non-monetary incentives and the Actions Filed for Other Purposes account for the majority of derivative actions involving listed companies. In other words, it is likely that derivative actions are only brought in those instances where the plaintiff shareholders or their attorneys have an incentive to pursue an action on an exceptional basis.

There would potentially be instances where a shareholder plaintiff or attorney may file an action for non-monetary incentives. In particular, it has been pointed out that more than a few derivative actions are filed by the shareholder ombudsman or others pursuant to a sense or belief of justice or the like.[505] Also, some of the actions brought by individual activists that aggressively exercise their shareholder rights in an effort to improve corporate governance may be filed based on non-monetary incentives. However, looking into the Studied Cases, only five derivative action cases fall under this category.

In addition, a shareholder having a conflict with the company may exploit a derivative action to reach a beneficial resolution (Actions Filed for Other Purposes). For example, a specific shareholder who has a labour dispute or commercial

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505 Puchniak and Nakahigashi, 'Japan's Love for Derivative Actions: Irrational Behavior and Non-Economic Motives as Rational Explanations for Shareholder Litigation', above n 441; Osugi, 'Kabunushi-Daihyou-Soshou Ha Wagakunide Donoyouni Kinou Shiteiruka[How Do Derivative Actions Funciton in Japan]'., above n 441.

dispute with the company has inherent interests (including dissatisfaction or animosity with management or other personal feelings), and may file a derivative action to pursue his or her own inherent personal interests and not the interests of shareholders as a whole. In such instances, there is an incentive to bring a derivative action that is unrelated to the benefits shareholders as a whole would directly gain from the action.

Compared to the large number of lawyer driven cases in the United States, under this study, with the exception of the actions filed for non-monetary incentives, it would be reasonable to infer that it is likely that most cases are not initiated by attorneys considering that repeat player attorneys were not found in the Studied Cases. This trend suggests that the monetary incentive is not sufficient enough for attorneys to take the lead in derivative actions.

5.4. Analysis of the Outcome

Next, I will analyse the results of the Studied Cases. First, I will summarise the results and address the trends in the 29 derivative action cases. The overall trend is that plaintiff shareholders have a low rate of success. The majority of the few cases in which the plaintiff shareholders prevailed are considered to have piggy-backed on public or private enforcement, and relied on information obtained in preceding procedures. Also, all of five cases thought to have been filed for non-monetary incentives have piggy-backed on prior public or private enforcement.

This is one factor as to why the plaintiff shareholders prevailed in two of these five cases. Meanwhile, the plaintiff shareholders posted an extremely low rate of success in the 19 cases classified as Actions Filed for Other Purpose, prevailing in only two of those cases. It is likely that the plaintiff shareholders exploited derivative actions for their own personal benefits, and had not reasonable basis for the filing of these actions. I will examine this in detail below.

5.4.1. Overall Trend

Hereunder the results in all the cases involving listed companies among the Studies Cases will be shown. Firstly, on the basis of the number of cases, of the 29 cases involving listed companies, two cases (6.9%) ended in decisions upholding all or a portion of the claims, the claims were dismissed on their merits in 13 cases (44.8%), the claims were rejected in six cases (20.7%), an acknowledgement of the claims was made by a defendant director in one case (3.4%), the complaints were withdrawn in five cases (17.2%), and settlements were reached in two cases (6.9%) (See Table 5 below).

Of the total 27 cases excluding the two cases in which the original complaints were withdrawn and re-filed, two cases (7.4%) ended in decisions upholding all or a portion of the claims, the claims were dismissed on their merits in 13 cases (48.1%), the claims were rejected in six cases (22.2%), an acknowledgement of the claims was made in one case (3.7%), the complaints were

withdrawn in three cases (11.1%), and settlements were reached in two cases (7.5%) (See Table 5 below).

On the basis of the number of companies involved, of the 22 listed companies involved in the Studied Cases, two companies (9.1%) had upholding judgements of all or a portion of the claims, 12 companies (54.5%) had dismissals of claims on their merits, two companies (9.1%) had rejections of claims, one company (3.7%) had an acknowledgement of the claim, three companies (13.6%) had withdrawals of complaints, and two companies (9.1%) had settlements (See Table 5 below).

Table 5: Outcomes of Derivative Actions on Behalf of Listed Companies

Of the 29 cases involving listed companies	No.	Ratio
Upholding a Claim	2	6.9%
Dismissing a Claim	13	44.8%
Dismissing a Claim Without Prejudice	6	20.7%
Acknowledging a Claim by Defendant	1	3.4%
Withdrawing an Action by Plaintiff	5	17.2%
Entering into a Settlement	2	6.9%
Total	29	100.0%

Of 27 cases excluding the two refiled cases	No.	Ratio
Upholding a Claim	2	7.4%
Dismissing a Claim	13	48.1%
Dismissing a Claim Without Prejudice	6	22.2%
Acknowledging a Claim by Defendant	1	3.7%
Withdrawing an Action by Plaintiff	3	11.1%
Entering into a Settlement	2	7.4%
Total	27	100.0%

Of the 22 companies sued	No.	Ratio
Upholding a Claim	2	9.1%
Dismissing a Claim	12	54.5%
Dismissing a Claim Without Prejudice	2	9.1%
Acknowledging a Claim by Defendant	1	4.5%
Withdrawing an Action by Plaintiff	3	13.6%
Entering into a Settlement	2	9.1%
Total	22	100.0%

5.4.2. Low Success Rate

A remarkable trend in these results is the low number of cases, just two cases or 6.9% (two cases or 7.4% excluding the re-filed cases, and 9.1% or two companies on the basis of the number of companies involved), resulted in decisions that upheld the plaintiff shareholders' claims. Together with the two cases on behalf of two companies, in which the claims were upheld, the one case on behalf of one company, in which the claims were acknowledged and the two cases on behalf of two companies, in which settlements were reached, the five cases in which the plaintiffs reached a favorable outcome accounted for only 17.2% of all 29 cases, and 18.5% of the 27 cases excluding the re-filed cases, and the five involved companies account for only 22.7% of the total 22 companies.

5.4.3. Correlation with Information Asymmetry Issue

There is a low rate of success for plaintiff shareholders in these types of derivative actions brought on behalf of listed companies. That being said, in what type of cases were the plaintiff shareholders successful? In considering this issue, I will address in interesting trend regarding the relationship to the information asymmetry problem.

Four of the five successful cases with regard to listed companies were each

filed following a criminal prosecution for a violation of the Political Funds Control Act, a criminal prosecution for a violation of the Financial Instruments and Exchange Act, an order for the payment of a surcharge for making false statements in securities reports, and a company prevailing in a suit against a former director seeking compensation of damages (in both the lower court and on appeal). In other words, all four of these cases were derivative actions that piggy-backed off of public enforcement or lawsuits brought by the companies in the pursuit of liability. The plaintiff shareholders did not collect evidence to pursue legal liability against the defendant directors, rather they relied on the evidence produced in public enforcement and lawsuits brought by the companies in the pursuit of liability. This mitigated the difficulty of gathering evidence arising from the asymmetry of information. In the one remaining case, the plaintiff shareholder was a former representative director of the company and was likely familiar with its internal information. In all five cases where the plaintiff shareholders enjoyed success, the plaintiff shareholders had access to information (evidence) supporting their claims against the defendant directors, and there existed no unevenness in the distribution of information.

In other words, the plaintiff shareholders only ended in success of filing derivative actions preceded by criminal prosecution or other proceedings or in derivative actions where the plaintiff shareholder was a corporate insider. Taking this trend into consideration, it is likely that there were other cases where director malfeasance was suspected to a certain extent, but the plaintiffs were unable to

meet the burden of proof due to the uneven distribution of information, resulting in a low percentage of cases in which the plaintiff shareholders prevailed or in a low rate of filing derivative actions.

5.4.4. Results of Actions Filed for Non-Monetary Incentives

Next, I will focus on the motives of the plaintiff shareholders in analysing the results of the derivative actions involving listed companies.

First I will focus on the five cases on behalf of five involved companies, which are regarded to have been brought for non-monetary incentives. The claim was upheld in one case (20.0% of the five cases), three cases (60.0%) were dismissed on their merits, and in one case (20.0%) the claim was acknowledged (Table 6). There were no other cases. The two cases in which the plaintiffs prevailed (the decision upholding the claim and the acknowledgement of the claim) accounted for 40.0% of the five cases, a higher rate of success than observed in the overall cases involving listed companies.

Table 6: Outcomes of Five Deriva Actions for Non-Monetary Incentives

Of 5 cases involving listed companies	No.	Ratio
Upholding a Claim	1	20.0%
Dismissing a Claim	3	60.0%
Dismissing a Claim Without Prejudice	0	0.0%
Acknowledging a Claim by Defendant	1	20.0%
Withdrawing an Action by Plaintiff	0	0.0%
Entering into a Settlement	0	0.0%
Total	5	100.0%

In relation to the asymmetry of information, the case that ended in a decision upholding the claim was preceded by criminal prosecution for a violation of the Political Funds Control Act, and the case ending in an acknowledgement of the claim was preceded by an order for the payment of a surcharge for making false statements in securities reports. In other words, both of these cases were piggy back derivative actions, and there was no uneven distribution of information.

Meanwhile, public or private enforcement also preceded the three cases that ended in a dismissal of the claims. One case was preceded by an order for the payment of a surcharge for making false statements in securities reports (the derivative suit found no false statements, and the claims were rejected), in one case the House of Councilors Committee on Financial Affairs conducted an inquiring on how tickets were purchased for a political fundraising party prescribed in Article 8-2 of the Political Funds Control Act, and in the remaining one case a newspaper reported on improper cash expenditures by a director, and the company established a third party committee that released a report of their investigation.

In other words, all of the five cases regarded to have been filed for non-monetary incentives were preceded by criminal prosecutions, an order for the payment of a surcharge, deliberation by the House of Councilors Committee on Financial Affairs and an investigation report by a third party committee, and the plaintiff shareholders prevailed in only two of the cases. In other words, all of the cases in which the plaintiff shareholders are thought to have filed actions for

non-monetary incentives piggy-backed off of public enforcement or private enforcement. As such, this study has demonstrated that shareholders who bring derivative actions for non-monetary incentives do not independently gather the evidence for pursuing liability, rather the information serving as the foundation for seeking legal liability against directors is made public and the derivative actions are filed in reliance on this information.

The information asymmetry problem is not so acute in instances preceded by criminal or administrative investigations and other public enforcement where the information regarding a director's breach of duty becomes public. The same applies in instances where a director's breach of duty becomes public under an investigative report by a third party committee set up by the company. The uneven distribution of information is also not a real barrier in those cases where the plaintiff shareholder is a former officer or other employee who knows of a company's internal information. Derivative actions may be brought in these limited cases.

This suggests that even shareholders who have non-monetary incentives for bringing derivative actions have difficulty determining the facts and proving the cause of claims required in the pursuit of liability due to the uneven distribution of information, and because of this, it is only possible to pursue legal action in those cases preceded by criminal prosecutions or other procedures, where there is no uneven distribution of information.

5.4.5. Results of Actions Filed for Other Purposes

Next, I will focus on the 19 cases regarded to be Actions Filed for Other Purposes. A decision upholding the claim was issued in one case (5.3% of 19 cases), the claims were dismissed on their merits in eight cases (42.1%), the claims were rejected in four cases (21.1%), no case was acknowledged the claims, five cases (26.3%) were withdrawn and a settlement was reached in one case (5.3%). The case in which the plaintiff shareholder's claim was upheld was preceded by a lawsuit brought by the company against a former director for the compensation of damages, where the company prevailed (in both the lower court and upon appeal), and the case that was settled was brought by a plaintiff shareholder who was a former representative director. Neither of these cases suffered from an uneven distribution of information.

Two of the 19 Actions Filed for Other Purposes were withdrawn and then re-filed due to procedural deficiencies. Of the 17 cases excluding these two cases that were initially withdrawn, a decision upholding the claim was issued in one case (5.9% of 17 cases), the claims were dismissed on their merits in eight cases (47.1%), the claims were rejected in four cases (23.5%), no cases acknowledged the claims, three cases (17.6%) were withdrawn and a settlement was reached in one case (5.9%).

In addition, of the 11 companies involved in these 19 Actions Filed for Other Purposes, the claim was upheld with regard to one company (9.1% of 11

companies), five companies (45.5%) had the claims dismissed, one company (9.1%) had the claim rejected, none of the companies acknowledged the claims, three companies (27.3%) had the claims withdrawn and one company (9.1%) settled (*see* Table 7)

Table 7: Outcomes of Deriva Actions for Other Purposes

Of the 19 cases involving listed companies	No.	Ratio
Upholding a Claim	1	5.3%
Dismissing a Claim	8	42.1%
Dismissing a Claim Without Prejudice	4	21.1%
Acknowledging a Claim by Defendant	0	0.0%
Withdrawing an Action by Plaintiff	5	26.3%
Entering into a Settlement	1	5.3%
Total	19	100.0%

Of 17 cases excluding the two refiled cases	No.	Ratio
Upholding a Claim	1	5.9%
Dismissing a Claim	8	47.1%
Dismissing a Claim Without Prejudice	4	23.5%
Acknowledging a Claim by Defendant	0	0.0%
Withdrawing an Action by Plaintiff	3	17.6%
Entering into a Settlement	1	5.9%
Total	17	100.0%

Of the 11 listed companies sued	No.	Ratio
Upholding a Claim	1	9.1%
Dismissing a Claim	5	45.5%
Dismissing a Claim Without Prejudice	1	9.1%
Acknowledging a Claim by Defendant	0	0.0%
Withdrawing an Action by Plaintiff	3	27.3%
Entering into a Settlement	1	9.1%
Total	11	100.0%

As demonstrated above, of the 19 Actions Filed for Other Purposes, a decision upholding the claim was issued in one case, one case ended in a settlement, and the plaintiff shareholders prevailed in only these two cases. These two success cases accounted for 10.5% of the 19 cases (11.8% of the 17 cases

excluding the two cases that were re-filed, and the two companies account for 18.2% of the 11 companies involved), revealing that there is a relatively low success rate in the overall cases on behalf of listed companies.

This low rate of plaintiff shareholders' success suggests that the plaintiff shareholders in the Actions Filed for Other Purposes were detached from the original intent of derivative actions, and the substance of the claims in the majority of such cases were more likely to lack reasonable evidence. If this is the case, a possible harmful effect of Japan's derivative action system which is designed for ease of use by shareholders is the occurrence of more than a few Actions Filed for Other Purposes that lack reasonable evidence, which incur wasteful costs at the defendant directors or companies responding to the actions, and harm the benefits of the shareholders as a whole.

5.4.6. Cases Applying the Business Judgment Rule

Here I will address the effect of the business judgment rule. Of the 29 derivative actions brought with regard to listed companies, 13 cases ended in a dismissal of the claims on their merits, but the claims were rejected through the application of the business judgment rule in only one case. In the majority of the remaining cases, the claims were dismissed due to the denial of the casual facts of the claims alleged by the plaintiff shareholders and for other reasons. Two cases ended in a decision upholding the claims, and one of these case lacked a resolution of the

board of directors regarding a business execution that corresponded to the disposal of and acceptance of assignment of important assets (Companies Act, Article 362, Paragraph 4 (1)), while the other involved a violation of the Political Funds Control Act, and the application of the business judgment rule to determine director liability for neglect of duties was not disputed in either of these cases.

These research results indicate with limitation to the Studied Cases, that the violation of director duties premised on the application of the business judgment rule is rarely disputed in cases involving listed companies. According to the accumulated precedent,[506] the factors for this phenomenon may be the standardisation of the interpretation and application of the business judgment rule and shareholder awareness that claims in a case applying the business judgment rule will likely be rejected, which in turn has resulted in the non-filing of derivative actions that dispute a director's business judgment.

5.4.7. Summary

As addressed above, the results of this research have revealed the following points.

(1) Plaintiff shareholders have a low rate of success (decisions

[506] See, e.g., *Shaholders v Apaman-Shop-Holdings, Inc.*, Tokyo District Court, 1304 Kinyu Shouji Hanrei 33 (2007), Tokyo High Court, 2-91 Hanrei Jihou 90 (2008), Supreme Court, 234 Saikou Saibansho Saibanshu Minji 225 (2010) (Tokyo District Court, Tokyo High Court and Supreme Court of Japan).

upholding claims, acknowledgement of claims or settlement) in only about 20% of the cases involving listed companies.

(2) The four of the five cases in which the plaintiff shareholders prevailed followed criminal prosecutions, an order for the payment of a surcharge and a suit filed by the company, the remaining one case was brought by a former representative director as the plaintiff shareholder, and none of these cases would not suffer from an uneven distribution of information.

(3) All five of the cases brought for non-monetary incentives were filed after criminal prosecutions, an order for the payment of a surcharge, deliberation by the Diet, an investigation report by a third party committee, and other proceedings. The plaintiff shareholders have prevailed (upholding of claims, acknowledge of claims or settlement) in two of these cases. It can be assumed that the trend of piggyback may lead to a high rate of success (40.0% of the five cases).

(4) Plaintiff shareholders prevailed in only two of the 19 Actions Filed for Other Purposes (a success rate of 10.5%). This is likely due to the fact that a majority of the Actions Filed for Other Purposes were derivative actions that lacked reasonable evidence.

5.5. Conclusion

Derivative actions grant shareholders the authority to pursue liability on behalf of the company when the filing of an action against a director is required but the other directors collude not to take action, ensuring a means for the compensation of damages ex-post, and these actions also serve as deterrence against director wrongdoing ex-ante.

However, the lack of a monetary incentive for the plaintiff shareholders serves as a structural barrier in derivative actions. An attorney's monetary incentive is also limited by his or her level of fees and the fee system. The uneven distribution of information may also be a barrier to the pursuit of liability through derivative actions. These factors may lead to cases where derivative actions are not pursued even though they may be the best means for seeking liability. This research has revealed that an extremely low percentage of listed companies are subject to derivative actions (each year, an average of 3.5 or 0.2% of the listed companies with head offices located in Tokyo see the conclusion of derivative actions), and that there are likely fewer derivative actions being brought than originally desired.

This is consistent with the results of my research regarding the attributes and motives of plaintiff shareholders. In reality, roughly 70% of the derivative actions brought at listed companies tend to be Actions Filed for Other Purposes that are based on the plaintiff shareholders' inherent interests. This suggests that

derivative actions are rarely filed in accordance with the original intent of the derivative action system due to a lack of a monetary incentive.

Based on the facts that Actions Filed for Other Purposes account for a majority of the derivative actions that are actually filed (19 of 29 cases) and plaintiff shareholders have a low rate of success in such cases (just 2 of 19 cases), it is possible that derivative actions that lack reasonable evidence supporting the cause of the claims are being filed in a disconnected manner from the original intent of the system, and produce results that run contrary to the interests of all shareholders. This is one harmful effect of Japan's derivative action system which was designed for ease-of-use by shareholders.

On the other hand, roughly 20% (five of 29 cases, and five of 22 companies) can be regarded as having been filed for non-economic incentives. These cases are brought by shareholder ombudsman and other activist shareholders. Additionally, what these cases have in common is that the derivative actions were filed after criminal prosecution or orders for the payment of surcharges, resulting in a high rate of success (two of five cases). This suggests that even though there are a number of cases brought for non-monetary incentives, it is possible that actions were brought specifically in those cases that were preceded by criminal prosecutions, orders for the payment of surcharges and other public proceedings where there was no uneven distribution of information.

As addressed above, this research was able to reveal some of the realities of derivative actions involving listed companies. However, there are still issues

that are difficult to examine. In particular, a harmful effect of derivative actions is the risk of litigation that runs contrary to the interests of all shareholders in exchange for granting a self-selected shareholder the power to act as a proxy for the company. The question of whether this is actually the case is an important issue that should be confirmed on an empirical basis. Abusive or inadequate litigation is an issue that is characteristic of derivative actions. Nevertheless, the question of whether the social costs of the potential of abusive or inadequate litigation exceed the social benefits of derivative actions' functions, including compensation, general deterrence and legal rule production, is difficult to be determined based on the data obtained in this research.

In addition, if you look solely at the specific companies subjected to derivative actions, if even a director violates his or her duties, the filing of a derivative action may not benefit shareholders as a whole since it may have a negative effect on the company's reputation and so forth. Nevertheless, for listed companies as a whole, the possibility that a shareholder holding a single unit of shares can file a suit at his or her own judgment if wrongdoing occurs has a general deterrence. The question of whether such general deterrence plays a role in the maintenance and improvement of corporate value is an important issue, but is a question that is difficult to confirm from the data obtained in this research.

CHAPTER VI: REALITIES OF DERIVATIVE ACTIONS AT CLOSED COMPANIES

6.1. Characteristics of Derivative Actions at Closed Companies

As stated above, of the 113 Studied Cases (96 sued companies), 84 cases (74.3% of the 113 cases) involved closed companies, and 74 of the sued companies (77.1% of 96 companies) were closed companies. As previously identified[507], it has been confirmed that a majority of the derivative actions actually filed involve closed companies.

Firstly, one characteristic of cases involving closed companies has been confirmed to be a high shareholding ratio for the plaintiff shareholders[508]. In

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507 Fukui, 'Kaishahou Sekougono Kabunushi-Daihyou-Soshou No Gaikyou [the General Report on Derivative Actions after the Enforcement of the Companies Act]', above n 276.

508 The shareholding ratios for plaintiff shareholders can only be confirmed from clues in the case records for those cases concluded by means other than judgment. In addition, in cases that are concluded by judgment, the shareholding ratios for plaintiff shareholders are not always affirmed in the court's reasons for the judgment. As such, data from the complaints, answers, preliminary briefs, other pleadings, documentary evidence and other case records are collected as clues to the shareholding ratios of the plaintiff shareholders. In more than a few cases there is a dispute among the parties regarding the shareholding ratio or there are no records that serve as clues, so the figures in this text is limited in

cases involving listed company the average shareholding ratio for the plaintiff shareholder was 1.3% and the median was 0.0%, while in cases involving closed companies the average shareholding ratio was 26.4% and the median was 19.9%.

A second characteristic is that in a majority of the cases involving closed companies the cause of the liability for the defendant directors alleged by the plaintiff shareholders involved the disbursement of company assets, conflict of interest transactions conducted without a resolution, receipt of officer remuneration without a resolution, the receipt of excessive officer remuneration with a resolution and other violations of law or breaches of fiduciary duties by the defendant directors.[509] Such allegations were made in at least 69 of the 84 cases.

A third characteristic is that the plaintiff shareholders have a higher rate of success in cases involving closed companies than in cases involving listed companies. Of the 84 cases involving closed companies, 12 cases (14.3% of 84 cases) ended in a decision upholding all or a portion of the claims, the claims were dismissed on their merits in 15 cases (17.9%), the claims were rejected in three cases (3.6%), the complaint was withdrawn in 27 cases (32.1%), and 27 cases (32.1%) ended in settlement. Nine cases were re-filed due to procedural deficiencies, and of the 75 cases excluding those which were initially withdrawn, 12 cases (16.0% of 75 cases) ended in a decision upholding all or a portion of the

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accuracy. Furthermore, in cases involving multiple shareholders, the shareholding ratio is stated as an aggregate sum.

[509] Companies Act s 355.

claims, the claims were dismissed on their merits in 15 cases (20.0%), the claims were rejected in three cases (4.0%), the complaint was withdrawn in 18 cases (24.0%), and 27 cases (36.0%) ended in settlement (Table 8). Looking at the 75 cases excluding the re-filed cases, a high percentage of the claims were upheld at 16.0%, and an even higher percentage of cases ended in settlement at 36.0%, which combine to a success rate of 52.0% for the plaintiff shareholders, much higher than the success ratio for cases involving listed companies.

Table 8: Outcomes of Derivative Actions on Behalf of Private Companies

Of the 84 cases involving Private companies	No.	Ratio
Upholding a Claim	12	14.3%
Dismissing a Claim	15	17.9%
Dismissing a Claim Without Prejudice	3	3.6%
Acknowledging a Claim by Defendant	0	0.0%
Withdrawing an Action by Plaintiff	27	32.1%
Entering into a Settlement	27	32.1%
Total	84	100.0%

Of the 75 cases excluding the nine re-filed case	No.	Ratio
Upholding a Claim	12	16.0%
Dismissing a Claim	15	20.0%
Dismissing a Claim Without Prejudice	3	4.0%
Acknowledging a Claim by Defendant	0	0.0%
Withdrawing an Action by Plaintiff	18	24.0%
Entering into a Settlement	27	36.0%
Total	75	100.0%

As indicated above, it can be confirmed that in cases involving closed companies the plaintiff shareholders have a high shareholding ratio, the plaintiff shareholders often allege violations of law or breaches of fiduciary duties on the part of the defendant directors, and the plaintiff shareholders have a high rate of

success.

This trend is consistent with the two potential issues in the derivative action system of the information asymmetry and the lack of incentives. Namely, in cases involving closed companies, there is a trend towards the filing of derivative actions in cases where the plaintiff shareholders are able to obtain internal information and they have a firm belief of defendant wrongdoing (no information asymmetry), if the plaintiff shareholder holds a high ratio of shares (has an incentive), and as a result thereof the plaintiff shareholders enjoy a high rate of success.

6.2. Cases Involving Closed Companies Ending in Settlement

As addressed above, a large percentage of cases involving closed companies are settled. Of the 84 cases, 27 ended in settlement, accounting for 32.1% of all cases. With the exclusion of the nine cases withdrawn for procedural deficiencies, the 27 settled cases accounted for 36.0% of all 75 cases.

It can be confirmed the following notable points in these settled cases. Firstly, it is possible to point out that the details of the settlements often strayed from the original structure of the derivative action system, and were flexible in nature in an effort to reach a critical resolution to the dispute. A derivative action is an action brought by a plaintiff shareholder on behalf of the company to seek compensation of damages or the like by the defendant director. As such, if a

settlement is reached, the defendant director should admit to the obligation to compensate the company for damages and promise to pay this compensation. However, this was only agreed to in nine of the 27 settled cases.

Instead, in nine cases the defendant shareholders agreed to pay money under the pretext of a settlement directly to the plaintiff shareholders and not the companies. This strays from the original structure of derivative actions, and reflects that the true cause of the disputes in settled cases on behalf of closed companies is conflicts between plaintiff shareholders and the defendant directors.

Additionally, in those cases where the settlement strayed from the structure of derivative actions, the shares of the plaintiff shareholders were purchased by the companies or the defendant directors in nine cases, and conversely the plaintiff shareholders purchased the shares of the defendant directors in six cases. In these 15 cases, the aim was to sell the shares held by the plaintiffs or the defendant directors to the other party or stakeholders to cut ties with the companies for the purpose of resolving the conflicts between shareholders serving as the background for the cases.

In addition, agreements regarding the future management structure were reached in two cases, and there were also cases in which the foregoing respective agreements overlapped.

As such, a flexible settlement aimed at resolving a substantial dispute is sought in many cases involving closed companies.

Secondly, another characteristic to be confirmed in these 27 settled cases

on behalf of closed companies is that there were separate disputes not directly related to the purpose of a derivative action (seeking compensation of damages from the company's directors). For example, there were 15 cases involving family or inheritance related disputes, two cases in which current or former officers were the plaintiff shareholders and separate disputes existed regarding their status as officers (excluding those cases confirmed to be family or inheritance related disputes), seven cases in which there were disputes between the plaintiff shareholders and the companies, or the plaintiff shareholders had worked with the defendant directors in the past, and three cases involving labor disputes between the plaintiff shareholders and the companies. Accordingly, it would be possibly deduced that resolution by settlement is actively sought out in cases where there are family or inheritance disputes, commercial disputes, labor disputes or disputes between officers.

Third, yet another characteristic to be confirmed in these settled cases on behalf of closed companies is that in a majority of the cases the cause of the director liability alleged by the plaintiff involved violations of law or breaches of fiduciary duties, and there was either no dispute regarding the fundamental facts related to the claims, or there was incontrovertible documentary evidence (bank passbooks, etc.) supporting the claims. In these cases, the defendant directors had resigned themselves to the fact that it was very likely that they would lose the cases and they had incentives to actively respond to settlement discussions. Meanwhile, for the plaintiff shareholders a conclusion by ruling was not a very reasonable

option since the compensation of damages in a prevailing claims would be paid to the company. Instead, it was more reasonable to substantially and critically resolve the dispute through a flexible settlement agreement. As a result, the plaintiff shareholders also had an incentive to settle, and consequently many of the cases ended in settlement.

As addressed above, a high percentage of cases involving closed companies are resolved by settlement, in particular, in cases where there are disputes separate from the derivative action, and the plaintiff shareholder is able to allege a breach of the defendant directors' fiduciary duties with considerable certainty, the trend is to actively reach an ultimate resolution to the dispute through a flexible settlement agreement that may include the disposition or sale of shares or direct payments to the plaintiff shareholders.

This trend suggests that the Companies Act of Japan has provided for "a derivative action system that is easy for shareholders to use", but due to the limited remedies available to minority shareholders to escape repression by majority shareholders (typically, the right to demand the purchase shares as a right of exit), in instances where there are disputes between the shareholders of closed companies (inheritance disputes, commercial disputes, and disputes involving management), derivative actions are being exploited as a means for settling these disputes, and the courts are also attempting to reach resolutions by settlement in line with the realities of the disputes.

CONCLUSION

Derivative actions have a compensation function, a deterrence effect and a legal rule production function, and are also effective in mitigating the agency problem between directors and shareholders. However, the issue of plaintiff shareholder incentives must be addressed in order for these effects to be demonstrated. Additionally, over-incentivising would intensify the agency problem between the interests of the self-selected plaintiff shareholders and shareholders as a whole. In considering how the derivative action system should be designed, a mechanism must be created that encourages the filing of necessary derivative actions and deters the filing of needless derivative actions.

At one time, derivative actions were highly valued in the United States, but subsequently came under increased criticism of abuse due to the large number of lawyer-driven actions, giving rise to the demand requirement and SLC control measures. Meanwhile, derivative actions have not historically been widely utilised in the United Kingdom where framework has been put in place for courts to examine the interests of companies in determining whether or not to allow a derivative action to continue.

On the other hand, in Japan, the Companies Act grants shareholders the right to easily bring a derivative action. It should be also noted that the Act does not implement measures for tackling with the agency problem of the self-selected

plaintiff shareholders. Given that the Japanese derivative action lacks sufficient safeguards, Japanese companies would potentially suffer from many unnecessary or illegitimate derivative actions brought about by the self-selected plaintiff. It is, however, interesting to note that, in Japan, a significant proportion of commercial litigation was said to occur in closely held companies. Also, it seemed reasonable to assume that notwithstanding the lack of safeguards, listed companies have not suffered badly from unnecessary actions. There are several possible explanations. In particular, both the Japanese version of the business judgement rule and the incentive problem for a plaintiff and its attorney would potentially cause the under-enforcement of derivative actions. To evaluate these hypothetical explanations, an empirical analysis of derivative actions against directors of listed companies was needed.

Therefore, this research conducted a study of the derivative actions filed in the Tokyo District Court which account for approximately one-third of all actions nationwide. With the cooperation of the Tokyo District Court, I was also given a special opportunity to view the court records for all derivative actions (a total of 113 cases) concluded by the Tokyo District Court in a six year period from 2011 through 2016. By examining the records for these cases, I will be able to make a comprehensive study of all the derivative actions that were actually concluded within a set time period at the Tokyo District Court. This study provides very important evidence for analysing the role that is actually being played by derivative actions as follows.

Firstly, there were a total of 96 companies covered by the 113 Studied Cases.

Of the 113 Studied Cases, 29 cases involved listed companies (25.7% of the 113 cases), and 84 cases involved closed companies (74.3%). Namely, listed companies account for only approximately one-fourth of the derivative actions that are actually filed, while closed companies account for the majority of the cases.

Secondly, focusing on derivative actions on behalf of listed companies, 29 of the 113 Studied Cases were brought on behalf of listed companies, and 22 listed companies were involved in these cases. This is the number of cases and the number of companies involved in the six year period subject to my investigation. Annually, each year an average of 4.8 derivative actions are concluded with respect to 3.7 listed companies with head offices located in Tokyo.

Even though Japan's derivative action system was designed with shareholder ease-of-filing in law, each year only an average of 3.7 or 0.2% of the listed companies under the jurisdiction of the Tokyo District Court find the conclusion of derivative actions actually brought in practice. The possible factors for a few actions would be the information asymmetry, the lack of monetary incentives, the burden of the continuous ownership requirement, and the various cost incurred by a company through the filing of a derivative action. As an exception, it may be possible that derivative actions are being filed in limited cases where there is no information asymmetry problem or where the plaintiff shareholders or attorneys have non-monetary incentives or other personal

motivations.

In fact, it can be confirmed that the cases brought for non-monetary incentives and the Actions Filed for Other Purposes account for the majority of derivative actions involving listed companies. In other words, it is likely that derivative actions are only brought in those instances where the plaintiff shareholders or their attorneys have an incentive to pursue an action on an exceptional basis. Compared to the large number of lawyer driven cases in the United States, under this study, with the exception of the actions filed for non-monetary incentives, it would be reasonable to infer that it is likely that most cases are not initiated by attorneys considering that repeat player attorneys were not found in the Studied Cases. This trend suggests that the monetary incentive is not sufficient enough for attorneys to take the lead in derivative actions.

As for the outcomes of the Studied Cases, the results of this research have revealed the following points.

(1) Plaintiff shareholders have a low rate of success (decisions upholding claims, acknowledgement of claims or settlement) in only about 20% of the cases involving listed companies;

(2) The four of the five cases in which the plaintiff shareholders prevailed followed criminal prosecutions, an order for the payment of a surcharge and a suit filed by the company, the remaining one case was brought by a former representative director as the plaintiff shareholder, and none of these cases would not suffer

from an uneven distribution of information;

(3) All five of the cases brought for non-monetary incentives were filed after criminal prosecutions, an order for the payment of a surcharge, deliberation by the Diet, an investigation report by a third party committee, and other proceedings. The plaintiff shareholders have prevailed (upholding of claims, acknowledge of claims or settlement) in two of these cases. It can be assumed that the trend of piggyback may lead to a high rate of success (40.0% of the five cases); and,

(4) Plaintiff shareholders prevailed in only two of the 19 Actions Filed for Other Purposes (a success rate of 10.5%). This is likely due to the fact that a majority of the Actions Filed for Other Purposes were derivative actions that lacked reasonable evidence.

Based on the facts that Actions Filed for Other Purposes account for a majority of the derivative actions that are actually filed (19 of 29 cases) and plaintiff shareholders have a low rate of success in such cases (just 2 of 19 cases), it is possible that derivative actions that lack reasonable evidence supporting the cause of the claims are being filed in a disconnected manner from the original intent of the system, and produce results that run contrary to the interests of all shareholders. This is one harmful effect of Japan's derivative action system which was designed for ease-of-use by shareholders. On the other hand, roughly 20% (five of 29 cases, and five of 22 companies) can be regarded as having been

filed for non-economic incentives. These cases are brought by shareholder ombudsman and other activist shareholders. Additionally, what these cases have in common is that the derivative actions were filed after criminal prosecution or orders for the payment of surcharges, resulting in a high rate of success (two of five cases). This suggests that even though there are a number of cases brought for non-monetary incentives, it is possible that actions were brought specifically in those cases that were preceded by criminal prosecutions, orders for the payment of surcharges and other public proceedings where there was no uneven distribution of information.

Thirdly, focusing on derivative actions on behalf of private companies, of the 113 Studied Cases (96 sued companies), 84 cases (74.3% of the 113 cases) involved closed companies, and 74 of the sued companies (77.1% of 96 companies) were closed companies. It can be confirmed that in cases involving closed companies the plaintiff shareholders have a high shareholding ratio, the plaintiff shareholders often allege violations of law or breaches of fiduciary duties on the part of the defendant directors, and the plaintiff shareholders have a high rate of success. This trend is consistent with the two potential issues in the derivative action system of the information asymmetry and the lack of incentives. Namely, in cases involving closed companies, there is a trend towards the filing of derivative actions in cases where the plaintiff shareholders are able to obtain internal information and they have a firm belief of defendant wrongdoing (no information asymmetry), if the plaintiff shareholder holds a high ratio of shares

(has an incentive), and as a result thereof the plaintiff shareholders enjoy a high rate of success.

As for outcomes, a large percentage of cases involving closed companies are settled. Of the 84 cases, 27 ended in settlement, accounting for 32.1% of all cases. A high percentage of cases involving closed companies are resolved by settlement, in particular, in cases where there are disputes separate from the derivative action, and the plaintiff shareholder is able to allege a breach of the defendant directors' fiduciary duties with considerable certainty, the trend is to actively reach an ultimate resolution to the dispute through a flexible settlement agreement that may include the disposition or sale of shares or direct payments to the plaintiff shareholders. This trend suggests that the Companies Act of Japan has provided for "a derivative action system that is easy for shareholders to use", but due to the limited remedies available to minority shareholders to escape repression by majority shareholders (typically, the right to demand the purchase shares as a right of exit), in instances where there are disputes between the shareholders of closed companies (inheritance disputes, commercial disputes, and disputes involving management), derivative actions are being exploited as a means for settling these disputes, and the courts are also attempting to reach resolutions by settlement in line with the realities of the disputes.

It can be said that Japan introduces the derivative action system without any gatekeepers to sort out unnecessary derivative actions. There is no guarantee that the plaintiff shareholder will have the proper incentives, information or

expertise to determine whether the filing of an action is appropriate in terms of the interests of shareholders as a whole or the interests of society as a whole. However, it would be reasonable to infer that not many listed companies in Japan suffer from abusive or inadequate derivative actions due to some factors including the incentive problem. Also, there is one advantage arising from the feature that an action that is filed by a specific shareholder cannot be blocked by the courts or the board of directors. For example, a broad recognition that derivative actions cannot be stopped once filed may work as a “commitment” that heightens the general deterrence of derivative actions. The question is whether derivative actions actually filed are effective or ineffective. If most of the filings result in pointless actions, stakeholders will lose trust in the system, defendant directors will simply be viewed as victims and the system may forfeit its general deterrence.[510] On the other hand, a greater number of meaningful actions would like increase the general deterrence.[511] Although the question of whether the social costs of the potential of abusive or inadequate litigation exceed the social benefits of derivative actions’ functions, including compensation, general deterrence and legal rule production, is difficult to be determined based on the data obtained in this research,

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[510] Erickson, 'Corporate Governance in the Courtroom: An Empirical Analysis', above n 38, 129; Cox, 'The Social Meaning of Shareholder Suits', above n 24, 6; Kato, 'Guroup Kigyou No Kisei-Houhou Ni Kansuru Ichikosatsu (3) [an Inquiry into Legal Measures for Regulating Corporate Groups (3)]', above n 26, 2211.

[511] Kato, 'Guroup Kigyou No Kisei-Houhou Ni Kansuru Ichikosatsu (3) [an Inquiry into Legal Measures for Regulating Corporate Groups (3)]', above n 26, 2211.

the results of this research show that Japan's choice of non-introducing gatekeepers of derivative actions would be potentially effective to enhance the functions of general deterrence and legal rule creation.

On the basis of the above, what are the implications for institutional reform? In considering this, listed companies and private companies should be considered separately.

In listed companies, shareholders can easily bring a shareholder derivative action and are not required to seek court approval, as in the UK, or to have their derivative action stopped by the decision of an independent board, as in the US. However, due to incentive problems and information asymmetries, the number of shareholder derivative actions in listed companies is not necessarily high. The few shareholder actions that do occur each year are often follow-on actions to public enforcement, and it is questionable to what extent the existence of shareholder actions is uniquely important. However, the ease with which shareholder actions can be initiated and the lack of mechanisms to stop them means that shareholder actions occur in some listed companies every year. In particular, shareholder ombudsmen, activists and social action groups have been the initiators and carriers of shareholder actions without direct economic incentives. When derivative actions are filed or significant decisions are publicised in large listed companies, they are often reported in the media. On each such occasion, directors of listed companies are likely to be widely aware that if they fail to discharge their duties of care and loyalty, they may be subject to a shareholder derivative action.

This deterrent function may well be working. The legal rules creation function is also at work. The emergence of many precedents and court cases challenging the duty of care and loyalty of directors of listed companies will lead to a concretisation of the code of conduct for directors. This will also create incentives for directors and secretary of many listed companies to take practical steps to improve the appropriateness and fairness of their decision-making mechanisms and to provide guidance on how to do so. Evaluating the admissibility of shareholder derivative lawsuits from the perspective of shareholders' interests would discourage the filing and continuation of shareholder derivative lawsuits, as it would not take into account their utility as public goods and externalities, such as the general function of deterring illegal acts and the function of creating legal norms. This makes it easier to suppress the filing and continuation of shareholder derivative actions. The absence of such a screening mechanism in Japan means that there are avenues for socially and ethically motivated shareholder derivative lawsuits to be filed regardless of economic incentives, and shareholder derivative lawsuits are filed every year in some listed companies, which may have a general function of deterring illegal acts and creating legal norms. This may be the case.

Is it therefore necessary to solve the incentive problem in order to further encourage the filing of shareholder derivative lawsuits? One possible institutional design might be, for example, to distribute part of the damages paid by the defendant directors to the company to the plaintiff shareholders if the plaintiff

shareholders win the shareholder derivative action, or to increase the contingency fees paid to the lawyers representing the plaintiff shareholders. However, encouraging the filing of shareholder derivative lawsuits also has side effects, as anecdotal evidence from the past in the US shows that the number of shareholder derivative lawsuits has increased, the harmful effects of abusive lawsuits have been widely recognised, and the pre-filing requirements and SLCs have been used to curb the filing. Shareholder derivative actions is costly, consumes the time and energy of defendant directors, damages the company's reputation, provides an opportunity for information leakage and creates a chilling effect. In addition, the source of the economic benefit to the plaintiff shareholders and their legal representatives must come from the company's own pockets. This creates a conflict of interest between the claimant shareholders and their legal representatives and other shareholders and creditors. Furthermore, internal governance with internal directors comprising the board used to dominate in Japan, but governance reforms have been underway since the formulation of the Corporate Governance Code in 2015. Supervisory boards with outside directors are now widespread in practice, and outside directors now account for more than one-third of board members in most listed companies. Japanese listed companies have diversified shareholdings, with an increasing proportion of shares held by institutional investors, and the involvement of institutional investors is becoming more active. Directors of listed companies are therefore under intense pressure from the capital markets and are increasingly aware that they must be accountable

to their stakeholders. In cases of serious misconduct, there is also public enforcement, including criminal and administrative sanctions. In the case of accounting scandals, it is not uncommon for companies to be subject to fines and criminal sanctions, as well as securities litigation. As can be seen from the above, there are social systems in place to discipline the management of listed companies, such as the progress of corporate governance reforms and the stable functioning of public enforcement, and there is no strong need to rely on the pursuit of legal liability through shareholder derivative suits.

As discussed above, shareholder derivative suits are readily available in listed companies in Japan if shareholders wish to bring them. However, they are not over-utilised due to the lack of economic incentives for plaintiff shareholders and their lawyers. Nevertheless, every year there are a number of socially or ethically motivated shareholder derivative lawsuits in some listed companies, so the system works to deter illegal acts and create legal norms, and on the other hand it has not led to a situation where abusive lawsuits are common. The current situation is perfectly balanced and no specific changes to the system are needed.

On the other hand, what about shareholder lawsuits in closed companies? This study has found that in closed companies, shareholder derivative actions are used as a means of resolving conflicts of opinion and interest between shareholders. In particular, because conflicts of interest between shareholders are a real problem, shareholder derivative actions in closed companies are often resolved by settlement. Flexible measures are also used to resolve the issue, such as one party buying out

the other party's shares to dissolve the relationship, or a settlement payment being made directly from the defendant directors to the plaintiff shareholders, rather than payment of damages to the company. This reality may be due to the legal system in Japan, where non-controlling shareholders who are oppressed by controlling shareholders have limited legal recourse. The Companies Act in Japan does not have a system similar to the UK's unfair prejudice system. Minority shareholders do not have the right to actively force the company or controlling shareholders to buy back their shares and exit. The right to buy back shares only arises in the context of mergers and other events or changes to the articles of association. In addition, it is the general meeting that decides on the distribution of dividends, and non-controlling shareholders do not receive an immediate return on their shares, even if the company grows sustainably. Controlling shareholders can receive remuneration for serving on the board, but non-controlling shareholders cannot. If non-controlling shareholders are oppressed, they have no other effective legal recourse. The only recourse is to bring a shareholder derivative action if the defendant director, who is also a controlling shareholder, has behaved in a problematic way, and to resolve the underlying shareholder conflicts through court proceedings. The way in which shareholder derivative actions are used in closed companies suggests that the legal system for regulating the relationship between controlling and non-controlling shareholders is inadequate and that the introduction of a legal system such as unfair prejudice should be considered.

APPENDIX

The Development in Articles of the Commercial Code/Companies Act regarding the Derivative Action[512]

1. The 1950 Code (after the 1950 Revision and the 1951 Revision)

Article 267.

(1) A shareholder having the shares consecutively for the preceding six months or more may demand that the Company, in writing, file an action for pursuing the liability of a Director.

(2) When the Company does not file such action within 30 days from the day of the demand under the preceding paragraph, the shareholder set forth in the preceding paragraph may file such action on behalf of the company.

(3) Notwithstanding the provisions of the preceding two paragraphs, in cases where the Company is likely to suffer irreparable harm through the elapse of the period set forth in the preceding paragraph, the shareholder set forth in paragraph (1) may immediately file an action set forth in the preceding paragraph.

(4) <u>When a shareholder files an action set forth in the preceding two paragraphs, the court may, in response to a petition by the defendant, order such shareholder to provide reasonable security.</u> [*This underlined paragraph was added in the 1951 Revision.*]

(5) <u>The provisions of paragraph (2) of Article 106 shall apply mutatis mutandis to a petition set forth in the preceding paragraph.</u> [*This underlined paragraph was added in the 1951 Revision.*]

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[512] Articles of the Codes except for CA2005 in Appendix were translated by the author basically depending on the translations of CA 2005, as of July 2014, contained in the Japanese Law Translation Database System, which is provided by Ministry of Justice, Japan. <http://www.japaneselawtranslation.go.jp/> accessed July 2014. Articles of the Codes of CA 2005 are cited from the above System.

Article 268.

(1) An action which has been brought against a Director by the Company or a shareholder shall be under the exclusive jurisdiction of the district court at the seat of the head office.

(2) A Shareholder or the Company may intervene in an action set forth in the preceding paragraph; provided, however, that this shall not apply when it will unduly delay the case or impose a massive burden on the court.

(3) The shareholder filing an action set forth in paragraph (2) of the preceding Article shall, after having brought an action, give notice of action to the Company without delay.

Article 268-2.

(1) In cases where a shareholder who has filed an action set forth in paragraph (2) of Article 267 wins the action, if the shareholder is to pay a fee to an attorney, the shareholder may demand that the Company pay a reasonable amount, not exceeding the amount of such fee.

(2) Even in cases where the shareholder loses the case, the shareholder shall not be obligated to compensate the Company for the damages, except when the shareholder was in bad faith.

(3) The provisions of the preceding two paragraphs shall apply mutatis mutandis to any shareholder who intervened in the action pursuant to the provisions of paragraph (2) of the preceding Article.

Article 268-3.

(1) In cases where an action set forth in paragraph (1) of Article 268 has been filed, if the plaintiff and defendant, in conspiracy, caused the court to render a judgement for the purpose of prejudicing the rights of the Company, which are the subject-matter of the action, the Company or shareholders may enter an appeal against the final judgement that became final and conclusive, by filing an action for a retrial.

(2) The provisions of the preceding Article shall apply mutatis mutandis to the appeal set forth in the preceding paragraph.

2. The 1993 Code (after the 1993 Revision)

Article 267.

(1) A shareholder having the shares consecutively for the preceding six months or more may demand that the Company, in writing, file an action for pursuing the liability of a Director. [*The same as Article 267(1) of the 1950 Code.*]

(2) When the Company does not file such action within 30 days from the day of the demand under the preceding paragraph, the shareholder set forth in the preceding paragraph may file such action on behalf of the company. [*The same as Article 267(2) of the 1950 Code.*]

(3) Notwithstanding the provisions of the preceding two paragraphs, in cases where the Company is likely to suffer irreparable harm through the elapse of the period set forth in the preceding paragraph, the shareholder set forth in paragraph (1) may immediately file an action set forth in the preceding paragraph. [*The same as Article 267(3) of the 1950 Code.*]

(4) An action set forth in the preceding two paragraphs shall be deemed to be an action relating to a claim which is not a claim based on a property right in calculating the value of the subject-matter of the action. [*This underlined paragraph was added in the 1993 Revision.*]

(5) When a shareholder files an action set forth in paragraph (2) or (3), the court may, in response to a petition by the defendant, order such shareholder to provide reasonable security. [*This paragraph is the same as Article 267(4) of the 1950 Code except for the underlined minor amendment.*]

(6) The provisions of paragraph (2) of Article 106 shall apply mutatis mutandis to a petition set forth in the preceding paragraph. [*The same as Article 267(5) of the 1950 Code.*]

Article 268.

(1) An action which has been brought against a Director by the Company or a shareholder shall be under the exclusive jurisdiction of the district court at the seat of the head office. [*The same as Article 268(1) of the 1950 Code.*]

(2) A Shareholder or the Company may intervene in an action set forth in the preceding paragraph; provided, however, that this shall not apply when it will unduly delay the case or impose a massive burden on the court. [*The same as Article 268(2) of the 1950 Code.*]

(3) The shareholder filing an action set forth in paragraph (2) of the preceding Article shall, after having brought an action, give notice of action to the Company without delay. [*The same as Article 268(3) of the 1950 Code.*]

Article 268-2.

(1) In cases where a shareholder who has filed an action set forth in paragraph (2) or (3) of Article 267 wins the action, if the shareholder has paid the necessary costs (excluding court costs) or is to pay a fee to an attorney, the shareholder may demand that the Company pay a reasonable amount, not exceeding the amount of such costs or the amount of such fee. [*This paragraph is the same as Article 268-2(1) of the 1950 Code except for the underlined amendments.*]

(2) Even in cases where the shareholder loses the case, the shareholder shall not be obligated to compensate the Company for the damages, except when the shareholder was in bad faith. [*The same as Article 268-2(2) of the 1950 Code.*]

(3) The provisions of the preceding two paragraphs shall apply mutatis mutandis to any shareholder who intervened in the action pursuant to the provisions of paragraph (2) of the preceding Article. [*The same as Article 268-2(3) of the 1950 Code.*]

Article 268-3.

(1) In cases where an action set forth in paragraph (1) of Article 268 has been filed, if the plaintiff and defendant, in conspiracy, caused the court to render a judgement for the purpose of prejudicing the rights of the Company, which are the subject-matter of the action, the Company or shareholders may enter an appeal against the final judgement that became final and conclusive, by filing an action for a retrial. [*The same as Article 268-3(1) of the 1950 Code.*]

(2) The provisions of the preceding Article shall apply mutatis mutandis to the appeal set forth in the preceding paragraph. [*The same as Article 268-3(2) of the 1950 Code.*]

3. The 2002 Code (after the 2002 Revisions)

Article 267.

(1) A shareholder having the shares consecutively for the preceding six months or more may demand that the Company, in writing, file an action for pursuing the liability of a Director. [*The same as Article 267(1) of the 1950 Code and the 1993 Code.*]

(2) The provisions of paragraph (2) and (3) of Article 204-2 shall apply mutatis mutandis to a demand, in writing, set forth in the preceding paragraph. [*This underlined paragraph was added in the 2002 Revision.*]

(3) When the Company does not file an action set forth in paragraph (1) within 60 days from the day of the demand under that paragraph, the shareholder who has made a demand set forth in that paragraph may file such action on behalf of the company. [*This paragraph is the same as Article 267 (2) of the 1950 Code and the 1993 Code except for the underlined minor amendments and the extension of the shareholder's waiting period from 30 days to 60 days.*]

(4) Notwithstanding the provisions of the preceding three paragraphs, in cases where the Company is likely to suffer irreparable harm through the elapse of the period set forth in the preceding paragraph, the shareholder set forth in paragraph (1) may immediately file an action set forth in the preceding paragraph. [*This paragraph is the same as Article 267 (3) of the 1950 Code and the 1993 Code except for the underlined minor amendment.*]

(5) An action set forth in the preceding two paragraphs shall be deemed to be an action relating to a claim which is not a claim based on a property right in calculating the value of the subject-matter of the action. [*The same as Article 267(4) of the 1950 Code and the 1993 Code.*]

(6) When a shareholder files an action set forth in paragraph (3) or (4), the court may, in response to a petition by the defendant, order such shareholder to provide reasonable security. [*This paragraph is the same as Article 267 (5) of the 1950 Code and the 1993 Code except for the underlined minor amendment.*]

(7) The provisions of paragraph (2) of Article 106 shall apply mutatis mutandis to a petition set forth in the preceding paragraph. [*The same as Article 267(6) of the 1950 Code and the 1993 Code.*]

Article 268.

(1) An action which has been brought against a Director by the Company or a shareholder shall be under the exclusive jurisdiction of the district court at the seat of the head office. [*The same as Article 268(1) of the 1950 Code and the 1993 Code.*]

(2) A Shareholder or the Company may intervene in an action set forth in the preceding paragraph; provided, however, that this shall not apply when it will unduly delay the case or impose a massive burden on the court. [*The same as Article 268(2) of the 1950 Code and the 1993 Code.*]

(3) The shareholder filing an action set forth in paragraph (3) or (4) of the preceding Article shall, after having brought an action, give notice of action to the Company without delay. [*This paragraph is the same as Article 268 (3) of the 1950 Code and the 1993 Code except for the underlined minor amendment.*]

(4) When a Company files an action set forth in paragraph (1), it shall give public notice to that effect or give notice thereof to its shareholders without delay. The same shall apply in cases where a Company is given notice of action pursuant to the preceding paragraph. [*This underlined paragraph was added in the 2002 Revision.*]

(5) The provisions of paragraph (5) of Article 266 shall not apply in cases where a Company effects a settlement in the action set forth in paragraph (1). [*This underlined paragraph was added in the 2002 Revision.*]

(6) In cases where a Company effects a settlement in the action set forth in paragraph (3) or (4) of the preceding Article, if the Company is not a party to the settlement, the court shall notify the Company of the contents of the settlement and give the Company notice to the effect that it should state its objection to such settlement, if any, within two weeks. [*This underlined paragraph was added in the 2002 Revision.*]

(7) In cases where the Company does not raise any objections in writing within the period set forth in the preceding paragraph, it shall be deemed to have given the approval for shareholders to effect a settlement with the contents of the notice under the provisions of that paragraph. In such cases, the provisions of paragraph (5) shall apply mutatis mutandis. [*This underlined paragraph was added in the 2002 Revision.*]

(8) The provisions of paragraph (9) of Article 266 shall apply mutatis mutandis to cases where a Company states a claim that it intervenes in an action set forth in paragraph (3) or (4) of the preceding Article to assist a Director. [*This underlined paragraph was added in the 2002 Revision.*]

Article 268-2.

(1) In cases where a shareholder who has filed an action set forth in paragraph (3) or (4) of Article 267 wins the action, if the shareholder has paid the necessary costs (excluding court costs) or is to pay a fee to an attorney or a legal professional corporation, the shareholder may demand that the Company pay a reasonable amount, not exceeding the amount of such costs or the amount of such fee. [*This paragraph is the same as Article 268-2(1) of the 1950 Code and the 1993 Code except for the underlined minor amendments.*]

(2) Even in cases where the shareholder loses the case, the shareholder shall not be obligated to compensate the Company for the damages, except when the shareholder was in bad faith. [*The same as Article 268-2(2) of the 1950 Code and the 1993 Code.*]

(3) The provisions of the preceding two paragraphs shall apply mutatis mutandis to any shareholder who intervened in the action pursuant to the provisions of paragraph (2) of the preceding Article. [*The same as Article 268-2(3) of the 1950 Code and the 1993 Code.*]

Article 268-3.

(1) In cases where an action set forth in paragraph (1) of Article 268 has been filed, if the plaintiff and defendant, in conspiracy, caused the court to render a judgement for the purpose of prejudicing the rights of the Company, which are the subject-matter of the action, the Company or shareholders may enter an

appeal against the final judgement that became final and conclusive, by filing an action for a retrial. [*The same as Article 268-3(1) of the 1950 Code and the 1993 Code.*]

(2) The provisions of the preceding Article shall apply mutatis mutandis to the appeal set forth in the preceding paragraph. [*The same as Article 268-3(2) of the 1950 Code and the 1993 Code.*]

4. Companies Act (Act No. 86 of July 26, 2005)

Chapter II Actions

Section 2 Action for Pursing the Liability, etc. of a Stock Company

(Action for Pursuing Liability, etc.)

Article 847.

(1) A shareholder (excluding a Holder of Shares Less than One Unit who is unable to exercise rights pursuant to the provisions of the articles of incorporation) having the shares consecutively for the preceding six months or more (or, in cases where a shorter period is prescribed in the articles of incorporation, such period or more) may demand that the Stock Company, in writing or by any other method prescribed by the applicable Ordinance of the Ministry of Justice, file an action for pursuing the liability of an incorporator, Director at Incorporation, Company Auditor at Incorporation, Officer, etc. (meaning the Officer, etc. prescribed in Article 423(1); hereinafter the same shall apply in this Article) or liquidator, an action seeking the return of the benefits set forth in Article 120(3) or an action seeking payment under the provisions of Article 212(1) or Article 285(1) (hereinafter referred to as an "Action for Pursuing Liability, etc." in this Section); provided, however, that this shall not apply in cases where the purpose of the Action for Pursuing Liability, etc. is to seek unlawful gains of such shareholder or a third party or to inflict damages on such Stock Company. [*Correspond to Article 267(1) of the 2002 Code except for the underlined proviso to the paragraph.*]

(2) With regard to application of the provisions of the preceding paragraph to a Stock Company that is not a Public Company, the phrase "A shareholder (excluding a Holder of Shares Less than One Unit who is unable to exercise rights pursuant to the provisions of the articles of incorporation)" in that paragraph shall be deemed to be replaced with "A shareholder." [*Newly incorporated in the 2007 Revision.*]

(3) When the Stock Company does not file an Action for Pursuing Liability, etc. within sixty days from the day of the demand under the provisions of paragraph (1), the shareholder who has made such demand may file an Action for Pursuing Liability, etc. on behalf of the Stock Company. [*Correspond to Article 267(3) of the 2002 Code.*]

(4) In cases where the Stock Company does not file an Action for Pursuing Liability, etc. within sixty days from the day of the demand under the provisions of paragraph (1), if there is a request by the shareholder who made such demand or the incorporator, Director at Incorporation, Company Auditor at Incorporation, Officer, etc. or liquidator set forth in that paragraph, it shall, without delay, notify the person who made such a request of the reason for not filing an Action for Pursuing Liability, etc. in writing or by any other method prescribed by the applicable Ordinance of the Ministry of Justice. [*Newly incorporated in the 2005 Revision.*]

(5) Notwithstanding the provisions of paragraphs (1) and (3), in cases where the Stock Company is likely to suffer irreparable harm through the elapse of the period set forth in those paragraphs, the shareholder set forth in paragraph (1) may immediately file an Action for Pursuing Liability, etc. on behalf of the Stock Company; provided, however, that this shall not apply in the cases prescribed in the proviso to that paragraph. [*Correspond to Article 267(4) of the 2002 Code.*]

(6) The Action for Pursuing Liability, etc. set forth in paragraph (3) or the preceding paragraph shall be deemed to be an action relating to a claim which is not a claim based on a property right in calculating the value of the subject-matter of the action. [*Correspond to Article 267(5) of the 2002 Code.*]

(7) When a shareholder files an Action for Pursuing Liability, etc., the court may, in response to a petition by the defendant, order such shareholder to provide reasonable security. [*Correspond to Article 267(6) of the 2002 Code.*]

(8) When the defendant intends to file the petition set forth in the preceding paragraph, the defendant shall make a prima facie showing that the Action for Pursuing Liability, etc. has been filed in bad faith. [*Correspond to Article 267(7) of the 2002 Code.*]

(Jurisdiction of an Action)

Article 848.

An Action for Pursuing Liability, etc. shall be under the exclusive jurisdiction of the district court having jurisdiction over the location of the head office of the Stock Company. [*Correspond to Article 268(1) of the 2002 Code.*]

(Intervention)

Article 849.

(1) A shareholder or a Stock Company may intervene in an action relating to an Action for Pursuing Liability, etc. either as a coparty or for assisting either of the parties; provided, however, that this shall not apply when it will unduly delay the court proceedings or impose an excessive administrative burden on the court. [*Correspond to Article 268(2) of the 2002 Code.*]

(2) In order for a Stock Company to intervene in an action relating to an Action for Pursuing Liability, etc. to assist a director (excluding an Audit Committee Member), executive officer, liquidator or a person who was formerly in such a position, it shall obtain the consent of the persons specified in the following items for the categories listed respectively in those items:

(i) Company with Company Auditors: the company auditor (in cases where there are two or more company auditors, each of such company auditors); or

(ii) Company with Committees: each Audit Committee Member.

[*Correspond to Article 268(8) of the 2002 Code.*]

(3) When a shareholder files an Action for Pursuing Liability, etc., the shareholder shall give notice of action to the Stock Company without delay. [*Correspond to Article 268(3) of the 2002 Code.*]

(4) When a Stock Company files an Action for Pursuing Liability, etc. or receives the notice of action set forth in the preceding paragraph, it shall give public notice to that effect or give notice thereof to its shareholders without delay. [*Correspond to Article 268(4) of the 2002 Code.*]

(5) With regard to application of the provisions of the preceding paragraph to a Stock Company that is not a Public Company, the phrase "give public notice to that effect or give notice thereof to its shareholders" in that paragraph shall be deemed to be replaced with "give notice to that effect to its shareholders." [*Newly incorporated in the 2005 Revision.*]

(Settlement)

Article 850.

(1) The provisions of Article 267 of the Code of Civil Procedure shall not apply to the subject matter of an action relating to an Action for Pursuing Liability, etc. in cases where a Stock Company is not a party to settlement in such action; provided, however, that this shall not apply when such Stock Company has given approval. [*Correspond to Article 268(6) of the 2002 Code.*]

(2) In the case prescribed in the preceding paragraph, the court shall notify the Stock Company of the contents of the settlement and give the Stock Company notice to the effect that it should state its objection to such settlement, if any, within two weeks. [*Correspond to Article 268(6) of the 2002 Code.*]

(3) In cases where the Stock Company does not raise any objections in writing within the period set forth in the preceding paragraph, it shall be deemed to have given the approval for shareholders to effect a settlement with the contents of the notice under the provisions of that paragraph. [*Correspond to Article 268(7) of the 2002 Code.*]

(4) The provisions of Article 55, Article 120(5), Article 424 (including the cases where it is applied mutatis mutandis pursuant to Article 486(4)), Article 462(3) (limited to the portion pertaining to the obligations assumed for the portion not exceeding the Distributable Amount prescribed in the proviso to that paragraph), Article 464(2) and Article 465(2) shall not apply in cases of effecting a settlement in an action relating to an Action for Pursuing Liability, etc. [*Correspond to Article 268(5) of the 2002 Code.*]

(Conduct of an Action of a Person Who is No Longer a Shareholder)

Article 851.

(1) Even where a shareholder who has filed an Action for Pursuing Liability, etc. or a shareholder who has intervened in an action relating to the Action for Pursuing Liability, etc. as a coparty ceases to be a shareholder during the pendency of such action, such person may conduct the action in the following cases:

(i) when such person acquires shares of the Wholly Owning Parent Company (meaning a Stock Company holding all of the Issued Shares of a certain Stock Company or a Stock Company prescribed by the applicable Ordinance of the Ministry of Justice as being equivalent thereto; hereinafter the same shall apply in this Article) of the relevant Stock Company through a Share Exchange or Share Transfer of such Stock Company; or

(ii) when such person acquires shares of the Stock Company incorporated through the merger or the Stock Company surviving a merger, or the Wholly Owning Parent Company thereof, through a merger in which the relevant Stock Company is a Company extinguished by the Merger

[*Newly incorporated in the 2005 Revision.*]

(2) The provisions of the preceding paragraph shall apply mutatis mutandis when, in the case set forth in item (i) of that paragraph (including the cases where it is applied mutatis mutandis pursuant to this paragraph or the following paragraph), the shareholder set forth in the preceding paragraph ceases to be a shareholder of shares of the Wholly Owning Parent Company of the relevant Stock Company during the pendency of the action set forth in that paragraph. In such cases, the term "the relevant Stock Company" in that paragraph (including the cases where it is applied mutatis mutandis pursuant to this paragraph or the following paragraph) shall be deemed to be replaced with "the relevant Wholly Owning Parent Company." [*Newly incorporated in the 2005 Revision.*]

(3) The provisions of paragraph (1) shall apply mutatis mutandis when, in the case set forth in item (ii) of that paragraph (including the cases where it is applied mutatis mutandis pursuant to the preceding paragraph or this

paragraph), the shareholder set forth in paragraph (1) ceases to be a shareholder of shares of the Stock Company incorporated through the merger or the Stock Company surviving a merger, or the Wholly Owning Parent Company thereof, during the pendency of the action set forth in that paragraph. In such cases, the term "the relevant Stock Company" in that paragraph (including the cases where it is applied mutatis mutandis pursuant to the preceding paragraph and this paragraph) shall be deemed to be replaced with "the Stock Company incorporated through the merger or the Stock Company surviving a merger, or the Wholly Owning Parent Company thereof." [*Newly incorporated in the 2005 Revision.*]

(Demand for Costs, etc.)

Article 852.

(1) In cases where a shareholder who has filed an Action for Pursuing Liability, etc. wins the action (including cases of partially winning the action), if the shareholder has paid the necessary costs (excluding court costs) or is to pay a fee to an attorney or a legal professional corporation with respect to the action relating to the Action for Pursuing Liability, etc., the shareholder may demand that the relevant Stock Company pay an amount that is found to be reasonable, not exceeding the amount of such costs or the amount of such fee. [*Correspond to Article 268-2(1) of the 2002 Code.*]

(2) Even in cases where a shareholder who has filed an Action for Pursuing Liability, etc. loses the case, the shareholder shall not be obligated to compensate the relevant Stock Company for the damages arising as a result thereof, except when the shareholder was in bad faith. [*Correspond to Article 268-2(2) of the 2002 Code.*]

(3) The provisions of the preceding two paragraphs shall apply mutatis mutandis to any shareholder who intervened in the action set forth in paragraph (1) of Article 849 pursuant to the provisions of that paragraph. [*Correspond to Article 268-2(3) of the 2002 Code.*]

(Action for a Retrial)

Article 853.

(1) In cases where an Action for Pursuing Liability, etc. has been filed, if the plaintiff and the defendant, in conspiracy, caused the court to render a judgment for the purpose of prejudicing the rights of the Stock Company, which are the subject-matter of the action relating to the Action for Pursuing Liability, etc., the Stock Company or shareholders may enter an appeal against the final judgment that became final and conclusive, by filing an action for a retrial. [*Correspond to Article 268-3(1) of the 2002 Code.*]
(2) The provisions of the preceding Article shall apply mutatis mutandis to the appeal for a retrial set forth in the preceding paragraph. [*Correspond to Article 268-3(2) of the 2002 Code.*]

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