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Master’s thesis

“Shareholders derivative litigation”

“Akcininkų išvestiniai ieškiniai“

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ABSTRACT AND KEY WORDS

This master’s thesis analyses the shareholders derivative litigation (action) mainly from substantive law perspective and where necessary – procedural law. Substantively, focusing on different EU and international legislation comparison for initiating such litigation. It explores the substantive law under which shareholders are able to challenge breaches of corporate directors fiduciary duties and seek the legal remedies available to the company. Procedurally, the thesis examines the framework that governs the initiation and conduct of derivative actions under different jurisdictions. Although, shareholders derivative litigation is quite rare in Lithuania, the thesis shall research the recent developments over the years.

Key words: Derivative action, pre-trial procedure, company law, share ownership threshold requirements, demand requirement.

INTRODUCTION

Relevance of the topic. Shareholder derivative litigation is a rare action taken by the shareholders in the states of continental law. The presumable problem regarding it could be due to its origin coming from states of common law. However, the relevance of this topic to the states of continental law and specifically – to the Republic of Lithuania has a few reasons.

Firstly, considering the non-existing legislative development of the shareholders derivative litigation (action) from the substantive law perspective in the Republic of Lithuania throughout the past two decades, besides the longstanding article 16 paragraph 1 subparagraph 5 of the Company Law of Republic of Lithuania, creates relevance to analyse the reasons behind its legislative stagnation. Consequently, it is also relevant to analyse whether the substantive law had any legislative or court jurisprudence developments.

Secondly, the topic was not academically analysed for the better part of the past decade in Republic of Lithuania. That leads to wonder whether there were any significant developments of the shareholders derivate litigation in the relevant court jurisprudence which would have potential for improvements in the existent legislation.

Thirdly, the more significant popularity of shareholders derivative litigation in the states of common law, or even in the other states of continental law which have more potential for corporate governance disputes, might have made certain progress throughout the better part of the two decades that could provide reasonable, substantial and meaningful incentives to review the legislation regulating the shareholders right to derivative litigation nationally. Or regardless, provide proper incentives from other legislators and make proposals for the Lithuanian legislator.

Henceforth, the aforementioned reasons create relevance for repeated academical analysis of this topic.

Aim. To analyse the substantive and procedural law framework of shareholders derivative litigation internationally and in the Republic of Lithuania during the better part of the past decade. In order to execute this aim, it is paramount to analyse the recent developments in the other continental and common law jurisdictions. The analysis will focus on the pre-trial requirements recognized internationally and whether its implementation in the Republic of Lithuania would have any positive or negative outcomes.

Tasks-Objectives.

- To analyse the fundamental (historical) rationale behind Shareholders Derivative Litigation;
- To analyse the fundamental purpose and objectives of derivative action;
- To analyse the legislation of continental and common law jurisdictions in relation to the shareholders derivative litigation from substantive law perspective;
- To analyse the positive and negative outcomes of the pre-trial procedure and determine whether it should be considered as anti-abuse measures, i.e. with only negative outcomes;
- To analyse whether there were any developments of the shareholders derivative action in the Republic of Lithuania and whether any legislative innovations could be considered by the legislator.

Methods.

- Comparative method;
- Comparative historical method;
- Logical analysis method;
- Statistical method.

Originality (Novelty). This thesis focuses on the developments of the past decade in terms of shareholder's right to initiate a derivative action from international and national perspective, as the topic of shareholders derivative litigation hasn't been researched for a better part of a decade (at least nationally). Notwithstanding that some parts of the thesis will repeat itself referring to structure items previously researched by other scholars (e.g. historical rationale behind derivative action), the author feels like they are integral part of the research and necessary for the essence of consistent train of thought. Nevertheless, previously researched parts of the thesis are presented from a different perspective in terms of scope, sources and conclusions. The thesis will essentially focus on substantial law developments and will include procedural law developments and / or statues only where and when deemed necessary to provide context or support the analysis of the substantial law developments.

Most important sources. Cross-jurisdictional Company Laws.

1. RATIONALE BEHIND DERIVATIVE ACTION

Before beginning analysing the comparison of shareholders derivate litigation in various jurisdictions, it is important to establish the understanding of the origin and concept of the shareholders right to invoke its right to derivative action against the management of a company where the shareholders have an ownership interest, following details of its purpose and objectives before beginning analysing the cross-jurisdictional foundations that might accordingly present legislative clarity on possible improvements in the shareholders derivative litigation legislative foundations in the Republic of Lithuania. Consequently, invoking the right to derivative action initiates the shareholders derivative litigation.

1.1. Origin and Concept of Derivative Action

In order to understand the origin and concept of the shareholders derivative litigation, one should begin by analysing it in the jurisdictions of common law, where its popularity is substantial considering the jurisdictions of continental law. Thus, one chooses to analyse the historical and normative foundations of shareholder derivative actions from the English substantive and procedural laws.

A substantial amount of scholars which choose to even briefly analyse the origin and concept of shareholder derivative action refer to its origin from procedural law of English common law, specifically referring to the *Foss v. Harbottle* (1843) 2 Hare 461, 67 ER 189 case. Despite its factual circumstances, the significant importance of this case is that the court laid down the precedent of establishing two important principles (or rather as referred to in common law - rules) of "Proper Plaintiff Rule" and the "Majority Rule". The "Proper Plaintiff Rule" rule establishes that when a wrong is done to a company, the proper party to bring a lawsuit is the company itself, not individual shareholders. This principle reinforced the idea that a corporation is a separate legal entity, distinct from its shareholders. And the "Majority Rule" establishes that if the majority of shareholders have the power to ratify or approve actions taken by directors, then individual shareholders cannot bring a lawsuit over those actions, as long as they are legal. Thus, it implemented what is now known as "derivative" litigation, because the *Foss v. Harbottle* case limited the circumstances in which the shareholders could invoke litigation individually, but established derivative actions, i.e. any subjects in control that are in violation of its fiduciary duties which bring detrimental consequences and would continue (or initially) not act to protect the interest of a legal entity, the shareholders were now able to step in to protect the interests of the legal entity by pursuing litigation by invoking its right to derivative action. However, it is essential to note that at the time that was the right of the majority shareholders, i.e. silencing the minority of the shareholders. Considering the verdict being made in 1843, it was undoubtedly ahead of its time, even though the aforementioned principles left the minority of shareholders unprotected. Nonetheless, over a certain period of time, specific exceptions were being development to the what is now established as the "rules of *Foss v. Harbottle*", i.e. four to be exact, which were the following:

1. Acts qualified as *ultra vires* or illegal. *Ultra vires* (beyond powers) acts are those actions taken by the legal entity or its management that are beyond what's permitted in the legal entity's constitution[1]. Regarding the illegality – minority shareholders can indicate a statutory or regulatory violation to protect their rights. However, and interesting certain court jurisprudence development (*Cockburn v. Newbridge Sanitary Steam Laundry Co.* (1915) and later *Smith v. Croft* (No 2) (1988)) established a now long standing principle of disinterested shareholders opinion/views. It states that even if the majority of disinterested shareholders oppose the derivative action, then the derivative action shall not proceed even if there is *prima facie* the case of illegality. This principle serves as a protection of the majority of shareholders against the minority of shareholders which could be abusing its right to invoke derivative action for their personal gain and without any substantive reason. This court jurisprudence development is now codified[2] and the court shall now take into consideration the majority (which is also usually the minority of the majority) of shareholders (a.k.a. members) views that have no personal interest regarding the invoked derivative action on whether to allow such derivative action to take place. Interesting legislation in this sense, because a minority of ownership interest held by the shareholders in the United Kingdom allows the court to question the credibility or substantiveness of minority

[1] As referred to by the current legislation of the Companies Act 2006 of the United Kingdom section 39 sub-section (1) stating the "Company's Capacity": *The validity of an act done by a company shall not be called into question on the ground of lack of capacity by reason of anything in the company's constitution.*

[2] Companies Act 2006 of the United Kingdom section 263 sub-section (4) stating the "Whether permission to be given": "*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.*"

shareholders derivative claims by trusting the disinterested shareholders to provide their views in order to have a comprehensive understanding of the matter at hand before giving the permission to litigate. Seemingly, the courts in United Kingdom have great regard to tiniest details in order to form the overall view of possible reasons behind shareholders derivative litigations.

2. Actions requiring a special majority. In cases provided for where special voting procedure would be necessary under the legal entity's constitution or under the Companies Act[3], it would undermine both if that could be sidestepped by ordinary resolutions[4] of a simple majority (usually 50% voting threshold), and no redress for aggrieved minorities to be allowed. Contrary to the first exception, this exception serves entirely for the benefit of minority shareholders since the special resolution (unless otherwise defined in the legal entity's constitution/articles of association) requires a 75% majority voting threshold to pass a significant or important decision, e.g. mergers and acquisitions, changing of legal entity's constitution/articles of association or even changing share class rights and etc. Otherwise, the minority wouldn't be able to challenge the simple majority if these decisions could be passed by the threshold of 50% or more, that would consequently lead to situations where the majority shareholders could impose decisions without sufficient acknowledgement or consideration of the minority shareholders views and interests. Specific court jurisprudence in the United Kingdom has contributed to this exception where it was finally established, or rather confirmed, that henceforth, when the legal entity's constitution/articles of association or Companies Act mandate the special voting procedure/special resolution, the minority of shareholders shall be able to challenge the majority shareholders actions taken violating the set out requirements by initiating the derivative action (*Edwards v. Halliwell* (1950) 2 All ER 1064). Briefly, the *Edwards v. Halliwell* factual circumstances were that the minority shareholders of a trade union challenged increased prices for maintaining the membership status.

[3] Companies Act 2006 of the United Kingdom section 283 sub-section (1) stating the "Special Resolutions": "*A special resolution of the members (or of a class of members) of a company means a resolution passed by a majority of not less than 75%.*"

[4] Companies Act 2006 of the United Kingdom section 282 sub-section (1) stating the "Ordinary Resolutions": "*An ordinary resolution of the members (or of a class of members) of a company means a resolution that is passed by a simple majority.*"

The union's constitution/articles of association required two-thirds (2/3) of the voting threshold to established the increased fee in a general shareholders meeting. However, the procedure wasn't adhered to, the fee was increased, the shareholders rallied to sue. As mentioned before, the outcome of the court's decision implemented another exception herein.

3. Personal rights of the shareholders. This rule allowed(s) to bypass the precedent of *Foss v. Harbottle* case in cases where the shareholder's personal rights are affected (e.g. share transfers, dividends, voting rights) in terms of participating in corporate governance as laid out in the legal entity's constitution. Any attempt to unjustly prevent these rights from being exercised shall be addressed/challenged in a court of law by the relevant shareholder (*Pender v. Lushington* (1877) 6 Ch D 70). In relation to the exception herein, the relevant case of *Pender v. Lushington* had the essential role of concreting the precedent where the shareholder's right to vote could not be contradicted by others because it is the shareholder's fundamental right of property. Putting the relevant factual circumstances in place, the plaintiff (J. Pender), as one of the shareholders of the company, figured he would transfer certain amount of his shares to nominees in order to increase its number of votes he could cast at a the general meeting. Other shareholder, which was *de facto* acting as chairman of the meeting – the defendant (Mr. Lushington) refused to count the votes of the plaintiff substantiating that these votes were part of an improper attempt to manipulate the outcome of the meeting resolutions provided that the company's constitution wouldn't allow to vote on more than 100 shares at any meeting (100 shares = 1 vote) and that "*the company shall not be affected by with notice of any trust*", which meant that the company does not recognize any trust arrangements between any shareholders and third parties regarding ownership of shares. The plaintiff bought 1000 shares and had them divided to a number of registered nominees under different names. Once defendant and its resolution supporters voted contrary to the wishes of the plaintiff, the plaintiff filed for an injunction together with its own resolution supporters. Therefore, the plaintiff enforced its and its nominees rights so that the votes were accounted for in the general meeting. The court ruled in favor of the plaintiff stating that voting rights are a personal right of the shareholders and the company could not refuse to recognize these votes and because these rights are personal, the shareholder has the right to pursue legal action

in order to protect them in cases where they are violated, even if they are contradicting the company's constitution or by the majority of shareholders. Thus, shareholders were now able to sue directly without having to sue in terms of derivative litigation under the name of the company for any violation of personal rights. Consequently, currently valid legislation in the United Kingdom recognizes shareholders rights to challenge company's actions which are unfairly prejudicial to their interests, such as voting rights, by petitioning the court[5].

4. Fraud on the minority. In the context of derivative litigation, this exception of fraud refers to an abuse of power in which the directors or the majority of shareholders, who control the legal entity, gain a benefit at the legal entity's expense. The foundation of this last exception was established by the precedent of *Atwool v. Merryweather* (1867 LR 5 EQ 464n) case. Allegedly, two directors (Merryweather and Whitworth) made certain profit from a sale that was left undisclosed to anyone and the contents of the sale contract concealed from any interested parties. In this way, the directors of the legal entity (who *de facto* held a controlling interest) engaged in actions that were detrimental to the legal entity and the minority of shareholders, but beneficial to themselves. The minority of the shareholders called the whole sale a fraud by substantiating the facts that in cases where no action could be brought, then directors who controlled the majority of the shares would always be able to vote for a transaction which effectively diverted the legal entity's money to them (directors, which *de facto* held a controlling interest) rather than benefitting the legal entity as a whole. Thus, the fraud of the minority exception was established whereas, the court recognized that the aforementioned actions of aforesaid directors qualified to an abuse of their fiduciary duties by misappropriation of legal entity's assets and since they held the controlling interest, it was resolved as unlikely that the legal entity would be able to pursue derivative litigation against them without establishing such exception herein. Significantly analogous court jurisprudence was formed even more than a hundred years later (*Daniels v. Daniels* (1978)),

[5] Companies Act 2006 of the United Kingdom section 994 sub-section (1) (a) stating the "Petition by company member": "*A member of a company may apply to the court by petition for an order under this Part on the ground — that the company's affairs are being or have been conducted in a manner that is unfairly prejudicial to the interests of members generally or of some part of its members (including at least himself).*"

which ascertains that *Atwool v. Merryweather* case established a timeless precedent.

Henceforth, the precedent of the *Foss v. Harbottle* case and its aforementioned exceptions/rules (especially the last - 4th one) has formed what is now reflected in the current United Kingdom's legislation as the "Derivative Claims"[6] (sections 260-264 in the Companies Act 2006). Given aforesaid legislative framework, shareholders are now able to initiate derivative litigation in any cases where there is managerial misconduct in an attempt to approve decisions which are detrimental to the legal entity and not necessarily beneficial to the legal entities own management. Undoubtedly, *Foss v. Harbottle* case laid down the foundations of shareholders derivative litigation for all common law and continental law jurisdictions to follow for best practices in place.

It wasn't long until the next exemplary common law jurisdiction – the United States of America established the first foundations of shareholders derivative litigation or as it is more commonly referred to in their jurisdiction court jurisprudence as – derivative suits. In fact, certain scholars were first to point out the aforementioned fact by stating that derivative suits have been "a recognized form of litigation in American courts since 1855" ("The Public and Private Faces of Derivative Lawsuits" by R. B. Thompson and R. S. Thomas, 2004, p. 1756). As it is rather expected from a common law jurisdiction, the aforementioned scholars were able to established the fact by referring to specific court jurisprudence in citing the U.S. Supreme Court's decision (*Dodge v. Woolsey*, 59 U.S. 331, 1856) which allegedly marked the initial implementation, or as the aforementioned scholars would rather refer to it as "acceptance", of the derivative suit, i.e. 12 years after the resolution of *Foss v. Harbottle* case in the United Kingdom. The United States of America has formalized the procedural requirements for derivative actions in federal courts by drafting the Federal Rules of Civil Procedure[7] which were first adopted by order of the Supreme Court on 20 December 1937, transmitted to Congress on 03 January 1938 and eventually - effective as of 16 September 1938.

[6] Companies Act 2006 of the United Kingdom section 260 sub-section (3) stating the "Derivative claims": "*A derivative claim under this Chapter may be brought only in respect of a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company. The cause of action may be against the director or another person (or both).*"

[7] The specific rule 23.1. adopted and effective as of 16 September 1938 is still effective to this day and the Federal Rules of the Civil Procedure of the U.S.A. (01 December 2014) clearly state the (a) prerequisites, (b) pleading requirements, (c) settlement, dismissal, and compromise standards between the states.

Be that as it may, the popularity of derivative actions in common law jurisdictions is undoubtedly substantial considering the late implementation of shareholders derivative litigation in continental law jurisdictions.

To name a few examples herein, the Federal Republic of Germany had firstly implemented somewhat of a concept during 1965 in their stock corporation act (Aktiengesetz – AktG, section 147 later and currently replaced by section 148) and later on during 2005 the shareholders derivative action was implemented by the Corporate Integrity and Rescission Law Modernisation Act (Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts – UMAG) (Schmolke, Klaus Ulrich, The Shareholder Derivative Action according to § 148 of the German Stock Corporation Act: Incentives of Current Law and Proposals for Reform, 2011). Even then, the scholars thought that the shareholders derivation litigation lacked sufficient legislative incentives to encourage shareholders to pursue the derivative litigation due to legislators fear of encouraging unsubstantiated litigations from shareholders perspective. Some scholars would even state that a derivative action which we are familiar with today had resemblance with what was used at the time to protect and *de facto* enforce a minority's of shareholders protection mechanism since 1884 (Hans C. Hirt, *The Enforcement of Directors' Duties pursuant to the Aktiengesetz: Present Law and Reform in Germany: Part 1*, 16 INT'L COMPANY & COMM. L. REV. 179, 184 (2005)). It is noteworthy to mention that the derivative action is only permitted for shareholders holding an interest in stock corporations (Aktiengesellschaft or AG) and not limited liability companies (Gesellschaft mit beschränkter Haftung or GmbH).

The French Republic were seemingly and unsurprisingly the first from continental law jurisdictions to present and implement an "*action sociale engagée ut singuli*" in its domestic law on commercial companies in 24 July 1867. Although it is difficult to establish clear regulatory framework behind such action from 1867, at the time it should have seemed like a great tool to initiate a derivative action if its framework aligns with today's French legislation. Currently, the "*action sociale engagée ut singuli*" is known as a tool for at least one or more shareholders to bring a social action for liability against the company directors/managers. Thus, the damages owned are to be paid not to the claimants in the action, but to the company on whose behalf they acted becoming a part of the company's treasury (French judiciary's Court of Cassation, Commercial Chamber 6 December 2017, appeal no. 16-21005, and the same Chamber 7 July 2009, appeal no. 08-15835). In cases where the possible mismanagement committed by the directors/managers of a company produced damages to one of the shareholders in a distinct way, the shareholder could admissibly initiate an action called an individual action or action "*ut singuli*". The judgment leading to the award of damages, initiated by him, enables him to receive compensation, and the financial awards granted are included in his personal assets. These proceedings ("*action sociale engagée ut singuli*" and "*ut singuli*") are permissible regardless of the number of shares held by the shareholder or the group of shareholders initiating them, i.e. no threshold requirements (French Civil Code article 1834-5, Commercial Code, articles L223-22 et seq., L225-252 et seq.).

In relation to the aforementioned and from the noted origin, it is well established by now that shareholders derivative litigation or derivative action's supposed concept was to establish proper corporate governance foundations in providing the shareholders a right to govern a managerial mismanagement of the legal entity with an indirect selfish incentive. Undoubtedly, one would define it as an indirect selfish incentive due to the fact that shareholders themselves would either way benefit from diminishing the managerial mismanagement, i.e. managers deliberate detrimental actions towards the legal entity or even insolvency. Historical origins of the shareholder derivative action were noted and implemented far back in the XIX century. However, some of the continental law countries implemented the derivative action only by late XX century (e.g. Belgium – 1991 (Belgium Corporate Code 1991 (CODE DES SOCIÉTÉS) art. 562), Norway – 1997 (Norwegian Public Limited Liability Companies Act (Aksjeloven), Section 17-1) and Italy – 1998 (Italian Civil Code (Codice Civile) article 2393-bis)) some even only during the XXI century (e.g. Republic of Lithuania – 2004 (Law on Companies (Akcinių bendrovių įstatymas) article 16 (1) paragraph 5).

1.2. Fundamental Purpose and Objectives of Derivative Action

Referring to the origin and concept of shareholders derivative litigation and what was established by former scholars analysing derivative actions, it can now be established that the main purposes of the derivative action is (1) for shareholders to intervene into the corporate governance by the very least protecting the company from the managerial misconduct and improving overall governance of the company and (2) for the protection of minority shareholders' interests (Mikalonienė, L. (2014). Išvestinio ieškinio samprata, paskirtis ir tikslai. Teisė, 93, p. 118–119). However, it seems like it alternatively serves for the purposes of (3) ensuring that the members of the management body are held responsible for breaches of their fiduciary duties and thus (as referring to the main (1) purpose) strengthening the corporate governance by discouraging managerial misconduct or even abuse of powers, (4) preventing conflicts of interest when members of the management body are or could be prioritizing their personal interests over the interests of a company which in a sense would serve as another alternative purpose of (5) preserving the company's assets (e.g. when members of the management body are approving detrimental resolutions for the company, however - beneficial through personal relations and thus using the company assets for personal gain).

The main objectives of the derivative action are (1) compensatory and only then (2) deterrent. The (1) compensatory objective serves to provide restitution to the company for the financial harm resulting from breaches of duty by members of the management body, by seeking redress for the losses inflicted on the company, which indirectly impact shareholders as well. Whilst the (2) deterrent objective serves as simply ensuring proper corporate governance through deterring its members of the management body from intentional detrimental resolutions since the aforementioned members shall be aware of the consequences if acted otherwise (*Ibid* Mikalonienė, L. (2014), p. 119). Even though both objectives are distinct, they are dependent on one another, e.g. a successful derivative action recovering losses from managerial misconduct would signal that such practices are not tolerated within (especially huge) stock corporations and similarly, initiating a derivative action without any financial recovery would still deter others from engaging in possible managerial misconduct if ever and even strengthen their own corporate governance to avoid ever being involved in one.

Scholars are still disputing whether the shareholders derivative litigation is mainly based on compensatory or deterrent objective. A substantial amount of continental law jurisdictions require a minimum share of ownership to initiate the derivative litigation thus questioning the motives of a shareholder initiating the derivative action based on these two objectives. Some scholars state that its most rational and main objective is *de facto* deterrent (Puchniak DW, Baum H, Ewing-Chow M, eds. The Derivative Action in Asia: A Comparative and Functional Approach. International Corporate Law and Financial Market Regulation. Cambridge University Press; 2012:1-20 p.) which would seem obscene considering the fact that any minimum share of ownership requirement in certain jurisdictions would not allow shareholders to pursue the deterrent objective, but in a sense, perhaps those particular jurisdictions legislators understanding is that the derivative action's main objective is *de facto* compensatory thus, they require minimum share of ownership requirements to diminish debates amongst other scholars in terms of these two objectives and the "*expense v. benefit*" of such action. From the perspective of "*expense v. benefit*" debate, many scholars throughout the world are positioning the question whether shareholders are likely to pursue derivative litigation baring the risk of being strangled with significant legal costs unless with a very high confidence of succeeding with the derivative claim because of being ordered to pay the legal costs of the successful party, since a shareholder's gains from the outcome of a successful claim is limited to their proportional share in the corporation's increased value (Jailani, Qamarul, Derivative Claims under the Companies Act 2006: In Need of Reform? (September 1, 2017), p. 93 and also other scholars Erickson, Jessica, The (Un)Changing Derivative Suit (March 2, 2018), p. 18).

In a bit of a paradox, it would then seem that the shareholder is unable to pursue the deterrent objective because the shareholder himself is deterred by the risk of bearing legal costs in case of an unsuccessful attempt to initiate the derivative litigation which in turn, should deter members of a management body from managerial misconduct. Meaning that the shareholders motives are only rational when the compensatory objective's benefit multiplied by the probability of derivative action's success would exceed the costs of litigation, including nonmonetary costs of time, devotion and efforts made to pursue justice. It would be more reasonable for shareholders to share the legal expenses, but the majority shareholders can often decline due to the fact that they might be accomplices of the members of the management and are not monitoring them thus, exploiting their position in the view of minority shareholders with lesser legitimate ownership interests, be that as it may, objectives of this research are not focusing on procedural law perspectives unless closely related. In relation to the aforementioned, the derivative action's deterrent objective is definitely less likely achievable by the minority shareholders which would conclude that the main derivative action's objective shall be compensatory. If determined otherwise, the deterrent objective effect would begin at the time a derivative action is in motion (filed) and would now not necessarily be contingent on a successful outcome in court. Thus, marking a possible exploitation from a broader perspective. Whatever the pursue of the shareholder is in terms of objectives to be met, at least one derivative action in a substantial corporation might be seem essential (once determined misconduct) to prevent potential managerial misconducts in the future by its deterrent objective (effect) despite the limited value of compensatory objective.

When it comes to costs and allocation of litigation risks, one of the exemplary examples could be a ruling made in Japan during 1993 where the court stated that stamp fees for derivative actions should follow a fixed rate, as their economic benefits to shareholders are immeasurable (Shiryou-ban Shouji-Houmu 70 (Tokyo High Court, 30 March 1993)).

Henceforth, the change drastically increased the number of filed derivative actions because of the diminished obscenely expensive filing fee which consequently lead the Japan to one of the leaders of derivative litigation in the world (Puchniak DW, Baum H, Ewing-Chow M, eds. The Derivative Action in Asia: A Comparative and Functional Approach. International Corporate Law and Financial Market Regulation. Cambridge University Press; 2012:130 p.).

Whether the objective of shareholders derivative action is mainly compensatory or deterrent, its noteworthy to comprehend the fact that corporate/company law requires enforcement mechanisms and without shareholders derivative litigation the members of the management would have barely any reason to comply with their fiduciary duties. Question is, whether the derivative litigation is worth the costs of litigation just to accomplish the deterrent objective (or rather - effect)? If yes, then perhaps an adoption of what is international recognised as the "demand requirement" would partly solve potential barriers to achieving the deterrent objective without any publicity and external costs? Further details on internationally recognised requirements prior initiation of the shareholders derivative litigation are provided in chapter 2.

2. INTERNATIONAL REQUIREMENTS: ANTI-ABUSE V. PRE-TRIAL?

The chapter herein shall analyse the international requirements to initiate the shareholders derivative litigation in order to provide incentives on possible legislative developments (or reasons for *legis status quo*) for the Republic of Lithuania. Different international court jurisprudence, substantive law or corporate governance practices set out different precedents on how shareholders are able to utilize their right to derivative action in order to achieve compensatory and / or deterrent objectives.

2.1. Dynamic Share Ownership Threshold Requirements

Seemingly the tendency behind the minimum share ownership requirement is non-existent in common law jurisdictions (e.g. UK, USA, Canada, Australia and New Zealand have different procedural requirements and, of course, require share ownership but without setting any legislative minimum share ownership threshold in their corporate/company laws) but an legislative invention of continental law jurisdictions that requires to hold a qualified percentage of the company's shares or a specific amount of capital to initiate shareholders derivative litigation. As priorly stated, since a shareholder's gains from the outcome of a successful claim is limited to their proportional share in the corporation's increased value, the only rationale behind setting the minimum threshold for initiate the derivate action seems like an objective to deter abusive shareholders who would try to involve themselves in the company's governance far too often without legitimate claims. Thus, it would seem rational to allow shareholders a right to dispute internal management decisions on a sort of a veto right prior engaging in litigation or more specifically - a demand requirement, even though most commonly same continental jurisdictions requiring minimum threshold requirement require shareholders to initiate a demand requirement to the their company's (supervisory) board too[8]. Otherwise, the minority shareholders which are not in a qualified percentage range of the minimum share ownership requirement have unproportionate capabilities to protect their rights. The deterrent objective of the shareholders derivative action seems unachievable and that *de facto* confirms the compensatory objective of the shareholders derivative action in jurisdictions where minimum threshold requirements are to be met. Accordingly, the company's management can neglect any minority shareholders opinion on corporate governance matters and focus on only the ones holding a qualified percentage. The aforementioned confirms the necessity in understanding the continental law legislator's reasoning behind minimum threshold requirements and their practical implementation.

Federal Republic of Germany would be considered as the one that took the most initiative in regulating the minimum share ownership threshold requirement in the EU as it has since 1998 to 2005 lowered its qualified percentage requirements from 10% to dashing equivalent of one hundredth of the share capital (1%) or to a stake in same of €100.000 (Germany's stock corporations act § 148(1) (AktG)) which is required for the shareholders to invoke its rights to derivative action. Interestingly enough, the same requirement is not applicable in cases where shareholders in a stock corporation in Germany choose to initiate a derivative action under corporate group law, against the controlling entity within the same group on companies (subsidiary to the parent company) (Germany's stock corporations act § 309 & § 317 (AktG)).

[8] Germany's stock corporations act § 148(1) (AktG) stipulates that: Stockholders, whose shares of stock, in the aggregate, are at least equivalent to one hundredth of the share capital or to a stake in same of 100,000 euros, at the point in time at which the petition is filed, may file a petition for leave to assert, in their own name, the company's claims to compensation set out in section 147 (1) sentence 1. The court will permit such an (derivative) action to be brought if: <…> 2. The stockholders provide proof that they have called on the company to itself bring an action, setting a reasonable time limit, but that this was to no avail;

The parent company usually holds a controlling interest of the subsidiary, meaning it owns the majority of the subsidiary (or plural – subsidiaries) shares. However, with potential minority shareholders who might be natural persons or other entities. Thus, as the legislator in Germany provides, these minority shareholders may seek to hold the parent company accountable for decisions that harm the subsidiary and without any required minimum share ownership threshold which could now be any number below 1% or to a stake in same of €100,000.

The Italian Republic has also an outstanding minimum share ownership requirement. Initiating a derivative action requires shareholders to hold at least 2.5% (One-fortieth (1/40)) of shares in publicly traded companies and 20% (One-fifth (1/5)) in private companies. While these thresholds can be adjusted by the company's articles of association, in the case of publicly traded firms, any adjustments are restricted to lowering the threshold rather than increasing it (Italian Civil Code (Codice Civile della Repubblica Italiana), art. 2393-bis(1), (2)).

Even People's Republic of China legislator (as a part of continental law countries) stipulate a minimum share ownership requirement of 1% or more. Its unique in a way that shareholders (of a company with limited liability or company limited by shares) are able to invoke their right to derivative action by holding the necessary minimum share ownership threshold individually or jointly in cases where some minority shareholders hold an interest below 1%. However, it has an additional requirement that shares (before initiating a derivative action) shall be held for at least 180 consecutive days (or more) but even then, shareholders are firstly required to make a demand to the board of supervisors or the supervisors (where such board is not formed) to bring a (derivate) lawsuit to the "people's court" and where a supervisor causes such losses to the company – to the board of directors or accordingly if one is not formed – to the executive director as expected by typical subordination chain of international corporate governance practices (Companies Law of the People's Republic of China, art. 152). A certain scholar analyzing the Chinese legislator's opinion on derivative action argued that the requirement for a shareholding threshold in derivative actions is based on the principle that such actions are fundamentally "representative" in nature. This implies that a shareholder initiating the action should hold sufficient shares (individually or jointly with other shareholders) to credibly act on behalf of or in alignment with the interests of the broader shareholder base (Lin, S. (2014). *Derivative actions in China*, 166 p.). That's true to the reasons that any successful claim would benefit the company alone and not the claimant/plaintiff and thus, all the shareholders together. However, the aforementioned scholar's reasoning in denying minimum thresholds requirement's necessity is understandable. To put in to perspective, even though the scholar laid down reasons are noticeable from the text of the China's legislator, this particular requirement is seen throughout some of the most exemplary countries legislations. Thus, its opinion stating that even though the minimum share ownership requirement is supposed to prevent abusive derivative litigation, it's not supposed to discourage valid derivative litigation (*Ibid*) is more than a valid reason to critically apply the minimum share ownership requirement. Be that as it may, China's legislator, by the very least, indicates that shareholders are allowed to reach the necessary threshold jointly, a practice that seems to be missing (at least from substantive laws perspective) in other exemplary continental law jurisdictions that explicitly state otherwise with an exception of France. In France, forming a group of litigants allows shareholders to collaborate and share the costs of litigation, such as attorney fees and discovery expenses, thereby reducing individual financial burdens (French Commercial Code (Code du Commerce) art. L.225-231) but prior appointing a group representative(s) in litigation (French Civil Code (Code civil) art. 1984).

French Republic's legislator indicates that if a shareholder wants to represent the group of litigants in derivative litigation then a minimum share ownership threshold requirement of at least 5% (one twentieth) of the share capital has to be owned by the representative shareholder. What also distinguished French regulations from other continental law jurisdictions is that the required percentage for the represented share capital is reduced in relation to the overall increase in share capital in this regard. Thus, the 5% requirement of minimum share ownership applies only in cases provided for where the share capital does not exceed €750,000. If the share capital exceeds €750,000, the law provides that the amount of the share capital shall be reduced accordingly by (1) 4% for the first €750,000, (2) 2.50% for the capital tranche between 750,000 and 7,500,000 euros, (3) 1% for the capital tranche between 7,500,000 and 15,000,000 euros and eventually (4) 0.50% for (any) surplus capital above 15,000,000 euros. Under any circumstances, the withdrawal from the proceedings by any of the shareholders (voluntarily or otherwise) does not affect the continuation of the derivative litigation (French Commercial Code art. R225-169).

A statement that the minimum share ownership requirement discourages meritless derivative claims from other shareholders wouldn't be completely correct and the requirement is not necessarily discouraging where such derivative litigation does not pose much of a popularity in the continental law jurisdictions in the first place.

Certain scholars analyzed the number of derivative litigations in the Republic of Korea (South Korea) between 1995 and 2013 which amounted to only 38 derivative litigations

(German and Asian perspectives on company law : law and policy perspectives / edited by Holger Fleischer, Hideki Kanda, Kon Sik Kim and Peter Mülbert. 2023. 229-230 p.). Now the Republic of Korea is seemingly one of the only continental law jurisdictions with the lowest (but still) requirement for the minimum share ownership threshold in order to initiate the derivative action. Any shareholder who holds no less than 1/100 (1%) of the total issued and outstanding shares of a stock (non-listed) company may demand that the company file an action against directors to enforce their liability, if the company fails to file such action within 30 days, the shareholder may immediately file such action on behalf of the company himself, in other words – file a derivative action (Republic of Korea Commercial Act chapter IV stock company art. 403). Any person who has continued to hold stocks equivalent to not less than 1/10,000 (0.01%) of the total number of stocks issued by listed companies for more than six months may exercise the right as a shareholder under Article 403 of the Commercial Act (Republic of Korea Commercial Act chapter IV stock company art. 542-6). Thus, it seems that the minority shareholders (of listed companies) have a right to derivative action with share ownership of 0.01% or above and it seems unlikely that anyone would own less than 0.01%.

In conclusion, the minimum share ownership requirement to file a derivative action doesn't seem effective in discouraging or deterring meritless derivative litigations and it is certainly not responsible for unpopularity of shareholders derivative litigation. However, such requirement might deter reasonably substantiated derivative litigations from the minority shareholders and thus, diminishing such a requirement doesn't seem likely to increase the overall derivative litigation popularity amongst the continental law jurisdictions. Once share ownership threshold requirement is met or otherwise void or non-existent, the shareholder shall step forward to the compliance with the demand's requirement.

2.2. Demand Requirement: Rationale, Recipient and its Expiration

If the share ownership threshold requirement is internationally known as the first barrier for shareholders to rightfully invoke their *locus standi* (the right or capacity to bring an action or to appear in a court), then the what is internationally known as the "demand requirement" is surely the second barrier in a pre-trial screening procedure before derivative litigation can begin. Generally from both common and continental law jurisdictions perspective, the demand requirement stipulates that the claimant/plaintiff shall first submit their claim to the management board of the company prior initiating the derivative litigation, unless doing so would be seem pointless (futile) or continually detrimental to the company. The demand's regulation varies over different jurisdictions and it certainly possess a few positive outcomes together with negative – rather bureaucratical nuances that sometimes would rather seem unnecessary but with certain exceptions – avoidable too.

To put it in to perspective, there's a uncomforting difference between the jurisdictions internationally because of an odd understand in regards to who should be the last addressee receiving the demand from the shareholders. In the Republic of Korea (South Korea) when a company files an action against a director and *vice versa*, the auditors shall represent the company in connection with such action. The same shall apply where a company is in receipt of a demand under Article 403 (1) – which stipulate the requirements for shareholders derivative litigation. (Republic of Korea Commercial Act chapter IV stock company art. 394). It certainly seems reasonable for an auditor, which explicitly acts independently from the management of the company under internationally recognized corporate governance principals (OECD (2023), G20/OECD Principles of Corporate Governance 2023, OECD Publishing, Paris, 32 p.), to receive such demand since in certain jurisdictions, external auditors are also obligated to assess and report on the company's corporate governance or the effectiveness of its internal controls related to financial reporting (essential to understand that the derivative action is of compensatory objective too and thus, closely related to the sound financials of the company). Specifically in South Korea, the auditors have duties and authority to demand reporting and to investigate the companies directors' performance (Republic of Korea Commercial Act chapter IV stock company art. 412). If the company has failed to file such action within 30 days from the date on which the demand from the shareholder was received, the shareholder may immediately file a derivative action on behalf of the company (Republic of Korea Commercial Act chapter IV stock company art. 403 (3)).

In the Republic of Singapore the demand requirement from the shareholders has to be presented to the director (or the board of directors – the companies act of Singapore does not require a company to have a specific amount of directors as long as its presumably one) by (1) providing a prior 14 days' notice of shareholders intention to invoke its *locus standi* and by (2) providing evidence that the director (or board of directors) failed to diligently prosecute, defend or discontinue the action or arbitration in the 14 days' notice period (Companies Act 1967 of Singapore – 2020 revised edition art. 216A (3) (a)). Considering that the director (or the board of directors) is usually the reason of a derivative action, here we see that the shareholder is responsible to directly communicate with the director in order to remind it of its fiduciary duties or wrongdoings without any representative of non-biased opinions prior to the shareholder establishing its *locus standi*.

Similarly to the Republic of Singapore, the Federal Republic of Germany has also a long standing demand requirement for shareholders to priorly seek the company itself to bring an action and only then the stockholders shall provide proof that they have called on the company to itself bring an action, setting a reasonable time limit, but that this was to no avail (Germany's stock corporations act § 148 (AktG)). The law does not explicitly indicate the addressee of shareholders demand besides from the company and thus, it is assumed that the addressee shall be the top management of the company – the management board or the supervisory board. Even though again the legislation lacks precision, certain scholars gathered that the reasonable time limit is considered two months prior shareholders *locus standi* can be invoked (Limitations on Derivative Actions in Germany and Japan to Prevent Abuse, Arno L. Eisen, 2012, 205 p.).

The State of Israel's legislator has chosen to regulate the demand's requirement quite precisely. Generally, Israel has a quite broad and clear regulatory framework when it comes to derivative actions. In fact, a whole dedicated chapter just for derivative actions and class actions combined. Interestingly enough, the article indicating the requirements prior initiation of derivative litigation indicates that any shareholder and any director of a company may bring a derivative action once requirements are met. Thus, either the shareholder or the director (of the board) are able to exercise the rights of a derivative action and achieve either compensatory or deterrent derivative action objectives. The demand shall be made in writing to the company demanding it to exercise its rights fully and it shall address the chairman of the board of directors (Israel Companies Act, § 194 (a), (b), (c)). As does the legislation of Singapore, the Israeli law provides that once the demand is received, the company (specifically the board of directors once the demand reached the chairman of the board) shall either (1) perform the act or adopt the decision by which the grounds for the demand are eliminated, (2) reject the plaintiff's (any shareholder's or director's) demand for reasons that shall be specified in the decision or (3) decide to bring action (Israel Companies Act, § 195). The shareholder shall receive a response from the chairman of the board within 45 days after the demand was submitted and then its admissibility shall be evaluated by the court (Israel Companies Act, § 196 and 197).

Some scholars believe that as long as shareholders derivative litigation remains rare the demand requirement would seem as ineffective from a pragmatic point of view (Mikalonienė,

L. (2015). Akcininko Teisė į Išvestinį Ieškinį: Ex Lege Prevencinės Priemonės, 212 p.). However, the demand's requirement does pose a certain positive and to some extent – effective outcome. Certain scholars properly argued that before any legal interventions could begin, it is reasonable that the company should be given the chance to address the misconduct of its corporate controllers, as it is the entity that has been directly harmed. When evaluating the significance and potential of continuing a claim, the supervisor, supervisory board, board of directors, or executive director must take various factors into account, such as the costs of the proceedings and potential damage to the company's reputation, before reaching a decision. If the company can resolve the issue through alternative methods, judicial action may not be necessary. In the demand's requirement perspective the company has the capacity to rectify the wrongdoing internally, which could ultimately benefit its overall well-being and avoid any external unnecessary attention in case of publicities (Zhao, J., & Wei, C. (2021). Shareholder remedies in China - developments towards a more effective, more accessible and fairer derivative action mechanism. Capital Markets Law Journal, 16(4), 17 p.).

It's important to comprehend the demand requirements' essence where the popularity of derivative action and derivative litigation as a whole is widespread – the United States of America. To put it in to perspective, certain scholars have highlighted that the distribution of derivative action filings across various jurisdictions within the U.S.A. reflects not only the geographical concentration of filings but also the influence of local legislation and procedural advantages. In 2023, Delaware filings accounted for 58 cases, the Southern District of New York had 31 filings, the Northern District of California also recorded 31 filings, and other states together contributed to an amount of 113 filings making it a total of astonishing 233 filings in just over the corresponding year of 2023 in the whole U.S.A.[9] (Laarni T. Bulan, Matthew Davis – Parallel Derivative Action Settlement Outcomes: 2023 Review and Analysis. 3 p.). Since the state of Delaware is known to be the most attractive jurisdiction for incorporation of a legal entity in the U.S.A, it's worthy of analyzation in terms of derivative action. Generally, the demand requirement is applicable in the state of Delaware and even required federal-wide. Pleading requirements stipulate that the complaint in a derivative action must state with particularity (1) any effort by the derivative plaintiff to obtain the desired action from the entity and (2) the reasons for not obtaining the action or making the effort and (3) allege facts supporting a reasonable inference that the derivative plaintiff has standing to sue

[9] The graphic illustrating these numbers over the last five years can be seen in Table 1.

derivatively under the law governing the entity (Rules of the Court of Chancery of the State of Delaware, Rule 23.1.). Thus, unlike in most of the continental law jurisdictions mentioned before, in the state of Delaware, shareholders are able to disregard the demand requirement as long as they believe that the effort would be useless – futile. The same applies on a federal level with an additional remark (both in Delaware and on a federal level) stating that once the derivative action is in motion, it can only be settled, voluntarily dismissed or compromised only with the court's approval (U.S.A Federal Rules of Civil Procedure – Rule 23.1. and Rules of the Court of Chancery of the State of Delaware, Rule 23.1. (d)). Interestingly enough, the U.S.A. has a specific model act which is being periodically amended by the Corporate Laws Committee of the Business Law Section of the American Bar Association called the Model Business Corporation Act which is not enacted yet whole states-wide[10] (not yet enacted in the states of Delaware, New York and California where derivative proceedings receive the most popularity as stated before). However, its unique in terms of providing clear regulatory framework for the derivative action proceedings and what is relevant here – demand requirement and its expiration. It states that shareholders are prohibited from initiating a derivative action until (1) a written demand has been made to the corporation requesting appropriate action, and (2) 90 days have passed since the demand was delivered, unless the shareholder has been notified prior to that time that the corporation has rejected the demand or unless waiting for the 90-day period to end would result in harm to the corporation and etc. (Revised Model Business Corporation Act § 7.42. updated April 5, 2024). Thus, the key difference here is that the not yet enacted Revised Model Business Corporation Act for the state of Delaware would require to change the legislation and remove shareholders rights to disregard the demand's requirement under their own discretion. Since it's the state that receives the highest amount of filings in the U.S.A, the enactment would pose problems as it is known that shareholders in Delaware rarely present the demand but rather disregard it by filing a derivative action straightly to court based on demand's futility (Erickson, J. (2010). Corporate governance in the courtroom: an empirical analysis. 1782-1784 p.). From the commentary part of the Revised Model Business Corporation Act it could be understood that the addressee of the demand from the shareholders shall be any of the directors.

In author's humble opinion, the demand requirement doesn't seem to pose any procedural hurdles or unnecessary bureaucracy if its legislated like in the state of Delaware, as long as the

[10] For the whole MBCA enactment map please see: https://www.americanbar.org/groups/business_law/resources/model-business-corporation-act/.

demand’s requirement can be disregarded under the shareholders own discretion based on the futility then it doesn’t seem to pose too many unnecessary problems but rather positive outcomes of shareholders being able to choose. Since they are the ones appointing the management board of their company, they could be and usually are well aware if their demand would be futile or not. In this way, the derivative action could be used for achieving several objectives rather than having scholars argue that its main objective is purely compensatory. Situations could arise where shareholders are not keen on pursuing litigation due to the time and costs it consumes. In such circumstances, the possibility to make a demand to reach the deterrent objective seems reasonable and avoids unnecessary expenses. At the same time, having the flexibility to disregard the demand’s requirement seems reasonable. Seemingly, international legislation confirms that after shareholders are met with the share ownership threshold and demand’s requirement, what’s left is the court’s discretion to refuse (a decision that refers to a case being dismissed due to procedural non-compliances), reject (a decision that refers to a case being dismissed due to its unsubstantiated merits) or approve the derivative action based on cause of action, conflict of interests (if any) and shareholders good faith.

3. STAGNATING NATIONAL REGULATION OF DERIVATIVE ACTION

The shareholders derivative action in the Republic of Lithuania has been facing a certain legislative stagnation since 2004. In the author’s humble opinion, a certain possible pre-trial procedure (as mentioned above) wouldn’t pose any procedural hurdle to initiate the shareholders derivative litigation as long as its flexible to a certain extent. If the legislation would allow legal entities to modify their approach to corporate governance by setting out a certain pre-trial procedure (e.g. in their articles of association) for shareholders to achieve their deterrent objectives where the management board seems to be approving detrimental resolutions, then the company itself would reduce expenses in case of any damages or avoid any damages with shareholders timely achieved deterrent objectives. It should be emphasised that the national company’s law also serves as a sort of handbook for corporate governance and it could present ways for shareholders to slightly intervene into its own owned company for the genuine purpose of deterring its management bodies from detrimental decisions and personal conflict of interests.

Be that as it may, the currently relevant court jurisprudence (over the past 5 years) of the Republic of Lithuania does not discuss possibilities of achieving the deterrent derivative action's objective because currently, the shareholders derivative litigation is mainly based on compensating the damages and the deterrent objective is understood as just a positive consequence of the litigation itself and in the end, not entirely noticed or afterwards specified internally in the shadows of specific company's privative meetings.

Although the sub-chapter analysing the internationally recognised share ownership threshold requirement by other continental law jurisdictions confirmed its futility from a certain perspective and especially where the derivative litigation is rare on its own, the demand requirement has potential to pose certain positive outcomes after it being flexibly implemented into national legislation. Prior to analysing the possible implementation of improvements from international practice, it's important to emphasize the outstanding legal uncertainties.

3.1. Legislative (Un)certainties: Any Progress?

The companies law of Republic of Lithuania governing public limited liability companies and private limited liability companies has a specific clause stipulating all of the recognised shareholders non-property rights and one specifically - to refer to the court with a claim requesting to redress damage incurred on a company resulting from nonfeasance or malfeasance (misconduct) by the manager of the company and members of the board of their duties prescribed by this the Company Law and other laws and the articles of association of the company as well as in other cases laid down by laws (Companies Law of Republic of Lithuania art. 16 paragraph 1 (5)). In other words, a right to derivative action. The legislator's intentions in indicating the main objective of this right is quite clear – compensatory objective due to requesting redress to incurred damages. However, shareholders role in vetoing any management bodies decisions and involving itself in corporate governance is neglected.

Firstly, the aforementioned regulation focuses on compensatory objective to redress damage incurred. Absence of demand's requirement disables shareholders to put a halt to any possibilities of potential damages in cases where shareholders would prefer to pursue the deterrent objective of derivative action and diminish any potential of damages before its incurred. The supreme court of Lithuania has confirmed that such non-property right is excluded from the shareholders list of non-property rights by stating that "<…> the fact that the shareholder is interested in the profitable operation of the company does not give him the right to act on behalf of the company and seek to implement its rights, which are not implemented by its management bodies. Since the shareholder is not given the right to demand compensation for damages caused to the company from third parties, except from the company's management bodies and their members, he is also not given the right to file a preventive lawsuit when the damage may still occur." (Supreme Court of Lithuania, Civil case no. e3K-3-41-421/2021, 10 March 2021).

Secondly, the aforementioned regulation is vague in terms of a possibility to initiate a derivative action against the supervisory board because even though private limited liability companies can refrain from forming a management board or a supervisory board – a public limited liability company is required to form either a management board or a supervisory board (Companies Law of Republic of Lithuania art. 19 (2)). Even though management board's and supervisory board's functions and responsibilities differ in a sense, there are cases where in a public limited liability company the supervisory board can appoint the manager (director) of the company and are responsible for supervising its activities which could be left (intentionally or not) neglected and thus – detrimental to the shareholders. In this case and in accordance with the aforementioned article defining the derivative action, shareholders would be unable to initiate a derivative action against the supervisory board and its detrimental decisions.

Thirdly, the regulation is vague in terms of indicating whether the shareholder has to *de facto* stay a shareholder for the whole period of the derivative litigation to achieve the compensatory objective. For example, the derivative litigation in the People's Republic of China does clearly indicate the requirement for a shareholder to stay a shareholder continuously in order to maintain its procedural status of a plaintiff for the whole period of the litigation (Lin, S. (2014). *Derivative actions in China*, 168 p.). Current legislation seems to leave the question open to interpretation on determining whether the shareholder had to be before – has to be doing or – is required to stay a shareholder after the damages occurred in order to maintain its procedural status as a claimant/plaintiff or initiate the derivative action in the first place.

Furthermore, the current regulation is understood as unextendible in terms of its interpretation and due to the this fact - shareholders derivative litigation is only feasible for shareholders of public and private limited liability companies. Thus, excluding other type and form of companies recognized in the Republic of Lithuania. In a case where the shareholders of a cooperative-form company requested the court to apply Article 16 paragraph 1 (5) of the Companies Law of the Republic of Lithuania, which defines derivative actions, the Supreme

Court of Lithuania stated that "<…> article 11 of the Law on cooperative companies (cooperatives) of the Republic of Lithuania, which regulates the rights of members of a cooperative company, does not establish the right to apply to the court with a claim, requesting compensation for damages to the cooperative company, which occurred due to the non-fulfillment or improper performance of the duties of the management bodies of this company, analogous to the shareholder's right enshrined in Article 16 paragraph 1 (5) of the Companies Law of the Republic of Lithuania. Such a right of the plaintiffs is not established (feasible) in the statutes of the Lithuanian Cooperative Union as well (Article 11 paragraph 3 of the Law on cooperative companies (cooperatives) of the Republic of Lithuania)." These circumstances create a situation where the shareholders are required to protect their own rights with other forms of legal methods. The case itself stipulated that the mere interest of a shareholder in the profitable activities of a company does not grant them the right to act on behalf of the company or to pursue rights that are not exercised by the company's management. A shareholder, except in specific cases prescribed by law, does not have the authority to approach the court to protect the rights of the legal entity they belong to. Only the entity itself, through its governing bodies, holds that right. A shareholder's attempt to defend the rights of the company through means not provided by law is not actionable in court. Thus the court reasoned that rejecting a lawsuit on these grounds does not infringe the shareholder's right to judicial protection, as they are not a proper party to initiate the lawsuit and therefore have no enforceable right to defend. The shareholder's right to judicial defense is safeguarded in other ways outlined by law, including the ability to request the court to investigate the entity's activities (as per Article 2.125, Paragraph 1, Clause 1 of the Civil Code and Supreme Court of Lithuania, Civil case no. e3K-3-202-915/2019, 04 July 2019).

Additionally, the uncertainties continue with a sense of confusion in terms of share ownership threshold requirement. What is the bare minimum threshold to initiate the derivative litigation? Accordingly, are shareholders only eligible to initiate the derivative litigation when damages occur whilst they are *de facto* shareholders? Are they able to invoke their right for damages that occurred retrospectively prior their acquisition of shares? Yet again, how many shares provide eligibility? What about former shareholders? Thankfully the supreme court of Lithuania had its grip on the aforementioned queries and provided their position regarding the letter of the law by *inter alia* stating that "<…> the right to file a derivative lawsuit against the manager and members of the board for damage caused to the company is acquired by a shareholder who owns at least one share of the company in accordance with the procedure set forth in Article 16 paragraph 1 (5) of the Companies Law of the Republic of Lithuania <…> it is also determined that all shareholders have the right to bring a derivative lawsuit, regardless of when they acquired the status of a shareholder - during or after the violation, only former shareholders of the company lose this right" (Supreme Court of Lithuania, Civil case no. e3K-3-13-378/2024, 13 February 2024). The quoted court jurisprudence provides perfect clearance in terms of initially raised queries. It is now understood that in private and public limited liability companies shareholders are able to initiate the derivative action by sole acquisition of the shareholder's status. Interestingly enough, a big enough public limited liability company in Lithuania could issue just enough of shares that their nominal value could be below what was even required in the previously mentioned South Korea (1/10,000 (0.01%) minimum share ownership threshold requirement for listed company shareholders). Since the ownership requirement in Lithuania is not based on the quantity of shares owned but on the sole fact of ownership, a shareholder who would invest in for example to a public limited liability company, duly incorporated in the Republic of Lithuania with the name "AUGA Group, AB" who's one issued share's nominal value is equal to €0,0585 shall be eligible to initiate a derivative action (to determine the nominal value of the "AUGA Group, AB" share, reference was made to the Nasdaq Baltic statistics). Understandably, the rationale for a shareholder to file a derivative action with the ownership that is worth of €0,0585 would be highly unreasonable, but yet – feasible? Be that as it may, the eligible proportion of redress from damages occurred would be equally insignificant and bearing in mind the litigation costs - no one would rationally initiate a derivative action on the circumstances of a single share ownership.

Interestingly enough there is another uncertainty. Are shareholders able to demand redress from damages occurred from its former managers or former members of the management board? A highly likely situation could occur where managers of members of the management board would voluntarily resign and force an end to their tenure after approving detrimental resolutions by seeking personal gain. The timeframe for shareholders to assess the damages caused by a resolution could take an excessive amount of time. In China, any third party that infringes the lawful rights and interests of a company and thus causes losses to the company can be brought to court by the shareholders whilst initiating a derivative action (Companies Law of the People's Republic of China, art. 152). Which essentially could be interpreted that a former manager/director is indeed a third party, even associated one. The United Kingdom's legislator clearly indicates that former director are subject to shareholders derivative litigation too (Companies Act 2006 of the United Kingdom section 260 (5) (a)). The only circumstance where the shareholders derivative action can be initiated against another person but not the managers and members of the management board is when the management of the company is temporarily entrusted to a third party – asset/property administrator (Supreme Court of Lithuania, Civil case no. e3K-3-202-915/2019, 04 July 2019). Yet no presumptions on current legislation could be properly considered to correctly interpret the national legislator's will to allow or reject shareholders right to initiate the derivative action against former managers and / or members of the management board.

Even if any more legal uncertainties were not mentioned herein, it is without a doubt concluded that the Companies Law governing shareholders derivative action in Lithuania should be gradually reviewed and amended so that the answers wouldn't have to be determined through court jurisprudence after extensive litigations on the highest caliber.

3.2. Opportunities for the Legislator: New Approaches?

Uncertainties raised through court jurisprudence are not the only factors to consider legislative inventions. From what was determined before, it is clear that the Lithuanian legislator has not established a pre-trial procedure or anti-abuse measures that would apply to shareholders prior to initiating shareholder derivative litigation. Perspective to have such process implemented by the legislator is highly unlikely given the currently valid legislation that was discussed in the previous sub-chapter and years of previously mentioned scholars remarks. Nevertheless, there's always potential in expanding the view of overall national corporate governance.

There's already scholars agreeing that a pre-trial procedure prior to initiating shareholders derivative litigation is not necessarily an anti-abuse system, but a "beneficial legal transplant" (Gelter, M. (2022). Preliminary Procedures in Shareholder Derivative Litigation: A Beneficial Legal Transplant? *European Company and Financial Law Review*, *19*(1), 26 p.). This author's reasoning behind the benefits of the pre-trial procedure focused on its implementation in the state of Delaware, U.S.A which indicated the shareholders unwillingness to pursue derivative litigation due to cost risks, especially since the most concerned party of such litigation are the minority shareholders with the lowest shareholding interest. Thus, a preliminary procedure is effective in reducing costs for shareholders in its preliminary stage where the success of its resolution is unknown and not necessarily expected to be successful. Continental law jurisdictions such as Germany and Israel or common law jurisdictions such as United Kingdom and Singapore already have a preliminary procedure as understood under chapter 2 of this thesis.

However, the objective for a pre-trial procedure implementation in the Republic of Lithuania would be meaningful from a different perspective and if regulated accordingly – wouldn't necessarily work as an anti-abuse measure to neglect shareholders capabilities to protect their rights. Well overall, sure, it would reduce litigation costs if it were to implement the preliminary procedure after which's approval it could seem that the derivative action's success is really likely, given that the shareholders are bearing the litigation expenses as the plaintiffs. But yet again, the aforementioned author (Gelter, M. (2022), *Ibid*) is seemingly agreeing that the shareholder's derivative litigation's main objective is compensatory. A way of a different concept for the Republic of Lithuania could be seen as focusing its pre-trial procedure to achieve the deterrent objective and the litigation - compensatory objective. Some could argue that it would involve the shareholders into corporate governance far too much and thus - frown upon. But certain continental law jurisdictions seem to think otherwise.

A way this concept could work is by implementing something that is already known in the state of Israel. The reason Israel's legislator is exemplary here is that from their derivative action's regulation seems that its intention is not necessarily focused on the compensatory objective of the derivative action, but rather embracing a flexible approach to allow the shareholder to include itself in the company's, that he's invested in, corporate governance and achieve the deterrent objective by utilizing the previously mentioned tool of a demand requirement. When the shareholders make a demand, the company can either (1) perform the act of adopt the decision by which the grounds for the demand are eliminated, (2) reject the shareholders demand for reasons that shall be specified in the decision or (3) decide to bring action as the shareholders requested (Israel Companies Act, § 195). The company is given 45 days to inform the shareholders of their decisions (Israel Companies Act, § 196). Then, shareholders are seemingly able to achieve the deterrent objective since the law, with court's approval, shall allow to bring the derivative action on four occasions – (1) in the shareholders opinion, the action taken or the decision adopted did not eliminate the grounds for the action, (2) the demand was rejected, (3) the company shall bring the derivative action to court itself, but didn't within 75 days after the notice or (4) the company failed to inform the shareholders on their decision in 45 days (Israel Companies Act, § 197). If the deterrent objective is achieved since the company eliminated the grounds for the action, then the pre-trial procedure by enforcing the demand requirement could be considered successful and the deterrent objective achieved together with the compensatory as it probably allowed to avoid damages.

Given the aforementioned regulation, the focus is on item no. 1 – shareholders opinion is that the action taken or the decision adopted did not eliminate the grounds for the action. This here allows shareholders to achieve the deterrent objective of a derivative action without having to go to court and endure any expenses at all. Understandably, it's a different preliminary procedure than compared to the aforementioned author's (Gelter, M. (2022)) since the derivative action would not reach the court's approval stage. Such stage is also regulated by the state of Israel by indicated that the court shall only approve if it is determined that the shareholders are (1) acting in good faith and to the benefit of the company and (2) if the shareholders are not able to fulfill the timeframe conditions prescribed by the law to await for the company's response to the demand's requirement because otherwise the matter is urgent and could be momentarily detrimental to the Company (Israel Companies Act, § 198). Thus, shareholders are also able to overstep the set out pre-trial requirements in cases of urgency or even futility like in the state of Delaware.

Similarly governed companies law in the Republic of Lithuania would allow shareholders to utilize their derivative action rights both for achieving the deterrent and compensatory objectives and being able to flexibly utilize their right to this tool by choosing which objective needs to be achieved or unknowingly achieving them both. The aforementioned exemplary regulation of derivative action could offer significant advantages in attracting foreign investors by establishing a flexible corporate governance framework that improves shareholders ability to effectively and efficiently protect their rights. Nevertheless, the intentions behind such action relies solely on the legislator.

CONCLUSIONS

1. The shareholders derivative litigation originated from the common law in the United Kingdom by the year 1843. Continental law was not far to follow the example and had the French Republic implement was is now known as the "*action sociale engagée ut singuli*" by the year 1867.
2. The shareholder derivative litigation serves to achieve two objectives – deterrent and / or compensatory. Even though many scholars believe its main objective is purely compensatory, in the author's humble opinion, the deterrent objective can be achieved prior any compensatory effect with proper legislative incentives and avoid shareholders having to endure any legal expenses or damages.
3. Considering internationally recognised requirements to initiate the shareholders derivative litigation, the requirements are established to serve as either anti-abuse measures or an effective pre-trial procedure. Thus, it can either achieve a both deterrent and compensatory objectives of the shareholders derivative litigation or just the deterrent whilst avoiding any legal expenses. All depends on the legislation and the legislator's incentives.
4. The Republic of Lithuania had very few developments of shareholders derivative litigation due to provided clearance from court jurisprudence. However, many legislative uncertainties remain and the national court jurisprudence is effectively reducing the amount of uncertainties. Nevertheless, clearance for the letter of the law should be deemed absolutely necessary to understand the legislator's incentives.
5. Establishing the concept of a pre-trial procedure, similar to the state of Israel's legislation, would improve national corporate governance practises allowing shareholders to achieve the deterrent objective of the derivative action and avoid any unnecessary damages prior to its occurrence or legal costs to reassure that its management is properly performing its fiduciary duties.
6. Even though the establishment of a pre-trial procedure to the Republic of Lithuania would improve its corporate governance and might even attract more foreign investors, the legislative stagnation since 2004 creates an impression that any legislative inventions are not likely to be implemented if simple legal uncertainties are still causing confusion to letter of the law.

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SUMMARY

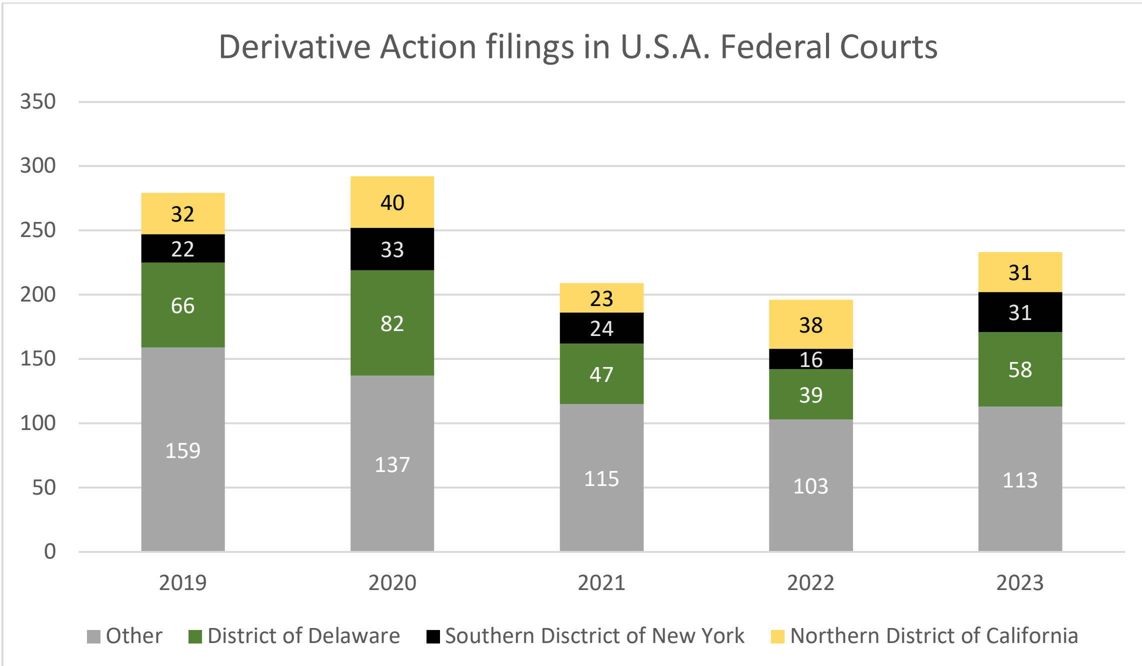
Shareholders Derivative Litigation

Algirdas Rasinskas

This master thesis provides analysis of the shareholders non-property right to invoke derivative action by examining cross-jurisdictional legal acts, legal literature and court jurisprudence. Since the author is from Lithuania, most of the research examined continental law jurisdictions legal framework but also embraced the importance of common law jurisdictions legal framework since the United Kingdom was determined as the origin of shareholders derivative litigation. The topic is revealed through the focus of derivative actions developments throughout the years with a specific agenda to understand whether there are any possible legislative inventions, exemplary corporate governance practices and legal (un)certainties elsewhere due to the determined legislative stagnation in Lithuania from the substantive law perspective.

The master thesis also analyses the concept of a pre-trial procedure disputing that it cannot be necessarily understood as an anti-abuse measure for shareholder to utilize in order to achieve the deterrent objective of the derivative action without having to endure any legal expenses if their main goal is not necessarily compensatory. Thus, it examines cross-jurisdictional framework in terms of requirements set forth in company laws and the rationale behind it for possibly proposing similar concept as a legislative invention to the legislator of the Republic of Lithuania since embracing shareholders non-property rights might draw more international investors. Due to the in-depth analysis of the shareholders derivative litigation, the author shall reveal exemplary legislative frameworks.

Table 1: Derivative action fillings in the U.S.A. federal courts over the last 5 years



Source: compiled by the author based on: Laarni T. Bulan, Matthew Davis – Parallel Derivative Action Settlement Outcomes: 2023 Review and Analysis. Available at: https://www.cornerstone.com/wp-content/uploads/2024/08/Parallel-Derivative-Action-Settlement-Outcomes-2023-Review-and-Analysis.pdf